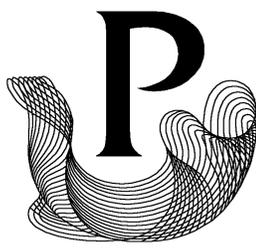




**POLLARD BANKNOTE LIMITED**

**2010 ANNUAL  
FINANCIAL STATEMENTS**

March 9, 2011



# **POLLARD BANKNOTE LIMITED**

*December 31 - 2010*

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND  
RESULTS OF OPERATIONS**

**FOR THE YEAR ENDED DECEMBER 31, 2010**

March 9, 2011

*This management's discussion and analysis ("MD&A") of Pollard Banknote Limited ("Pollard") for the year ended December 31, 2010, is prepared as at March 9, 2011, and should be read in conjunction with the accompanying financial statements of Pollard and the notes therein as at December 31, 2010. Results are reported in Canadian dollars and have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP" or "Canadian GAAP").*

*On May 14, 2010, Pollard Banknote Income Fund (the "Fund") and Pollard Holdings Limited Partnership ("Pollard LP") completed the conversion (the "Conversion") to a publically traded corporation. As there was no substantive change in ultimate ownership after the Conversion it was accounted for under the continuity of interests method. As a result, one consolidated financial statement, incorporating both the Fund and Pollard LP, has been prepared. Comparative figures have been restated to reflect the combined results of both entities.*

### **Forward-Looking Statements**

*Certain statements in this report may constitute "forward-looking" statements which involve known and unknown risks, uncertainties and other factors which may cause actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by such forward looking statements. When used in this document, such statements include such words as "may," "will," "expect," "believe," "plan" and other similar terminology. These statements reflect management's current expectations regarding future events and operating performance and speak only as of the date of this document. There should not be an expectation that such information will in all circumstances be updated, supplemented or revised whether as a result of new information, changing circumstances, future events or otherwise.*

### **Use of Non-GAAP Financial Measures**

Reference to "Adjusted EBITDA" is to earnings before interest, income taxes, amortization, unrealized foreign exchange gains and losses, mark-to-market gains and losses on foreign currency contracts and interest rate swaps, and certain non-recurring items including facility closing reserve, conversion expenses, warranty reserve accruals and restructuring costs. Adjusted EBITDA is an important metric used by many investors to compare issuers on the basis of the ability to generate cash from operations and management believes that, in addition to Net Income, Adjusted EBITDA is a useful supplementary measure.

Adjusted EBITDA is a measure not recognized under Canadian GAAP and does not have a standardized meaning prescribed by Canadian GAAP. Therefore, this measure may not be comparable to similar measures presented by other entities. Investors are cautioned that Adjusted EBITDA should not be construed as an alternative to Net Income determined in accordance with Canadian GAAP as an indicator of Pollard's performance or to cash flows from operating, investing and financing activities as measures of liquidity and cash flows.

## **Basis of Presentation**

The results of operations in the following discussions encompass the consolidated results of Pollard for the year ended December 31, 2010. All figures are in millions except for per share amounts.

These consolidated financial statements reflect the entities conducting the business of manufacturing and selling lottery and gaming products of the Pollard group as a corporation subsequent to May 14, 2010 and as an income trust and limited partnership prior to the Conversion. All references to "common shares" collectively refer to Pollard's common shares on and subsequent to May 14, 2010 and Fund Units and Class B and C Limited Partnership Units prior to the Conversion. All references to "dividends" refer to dividends paid or payable to holders of Pollard common shares on and subsequent to May 14, 2010 and to distributions payable to Fund Unitholders and Class B and C limited partnership Unitholders prior to the Conversion. All references to "shareholders" refer collectively to holders of Pollard common shares on and subsequent to May 14, 2010 and to Fund Unitholders and Class B and C limited partnership Unitholders prior to the Conversion.

# POLLARD BANKNOTE LIMITED

## Overview

Pollard Banknote Limited ("Pollard") is one of the leading providers of products and services to lottery and charitable gaming industries throughout the world. Management believes Pollard is the largest provider of instant-win scratch tickets ("instant tickets") based in Canada and the second largest producer of instant tickets in the world.

Pollard produces and provides a comprehensive line of instant tickets and lottery services including: licensed products, distribution, retail telephone selling ("tel-sell"), marketing and instant ticket vending machines. In addition, Pollard's charitable gaming product line includes pull-tab (or break-open) tickets, bingo paper, pull-tab vending machines and ancillary products such as pull-tab counting machines. Pollard also markets products to the commercial gaming and security sector including such items as promotional scratch and win tickets, transit tickets and parking passes.

Pollard's lottery products are sold extensively throughout Canada, the United States and the rest of the world, wherever applicable laws and regulations authorize their use. Pollard serves over 50 instant ticket lotteries including a number of the largest lotteries throughout the world. Charitable gaming products are mostly sold in the United States and Canada where permitted by gaming regulatory authorities. Pollard serves a highly diversified customer base in the charitable gaming market of over 250 independent distributors with the majority of revenue generated from repeat business.

## Product line breakdown of revenue

	Year ended December 31, 2010	Year ended December 31, 2009
Instant Tickets	88%	88%
Charitable Gaming Products	11%	11%
Vending Machines	1%	1%

## Geographic breakdown of revenue

	Year ended December 31, 2010	Year ended December 31, 2009
United States	47%	56%
Canada	24%	24%
International	29%	20%

## **Formation of the Corporation**

Pollard was incorporated under the laws of Canada on March 26, 2010, for purposes of implementing the Conversion of the organization from an income fund to a corporation.

## **Conversion to a Corporation**

On January 28, 2010, the Trustees of the Fund, in conjunction with the Board of Directors of Pollard Banknote GP Limited, General Partner of Pollard LP, approved in principle a plan to convert Pollard Banknote Income Fund into a publicly traded corporation. On April 6, 2010, the Ontario Supreme Court of Justice approved the preliminary plan of arrangement for the Conversion. On May 6, 2010, the Unitholders of the Fund voted in favour of the Conversion and on May 13, 2010, the Ontario Securities Commission approved the final plan of arrangement.

The Conversion utilized legislative tax-free conversion options and became effective May 14, 2010. Pursuant to the terms of the Conversion, holders of Fund Units received, in exchange for each of their Fund Units, one common share of Pollard. Pollard Equities Limited ("Equities"), the holder of the Class B and Class C Limited Partnership Units (collectively, the "Exchangeable LP Units") of Pollard LP and the associated Special Voting Units, received, in exchange for each group of one Exchangeable LP Unit (together with the accompanying Special Voting Unit), one common share of Pollard.

As a result of the Conversion, Pollard became the 100% owner of both the Fund and Pollard LP, with Pollard LP continuing to operate the business of manufacturing and selling lottery and gaming products.

Prior to the Conversion, on January 6, 2010, Pollard declared a dividend of \$0.0475 for the month of January, payable February 15, 2010. On January 28, 2010, Pollard changed its dividend policy. Dividends of \$0.01 per share were declared for the months of February (payable March 15, 2010), March (payable April 15, 2010) and April (payable May 14, 2010).

Following the Conversion, Pollard initiated a dividend rate of \$0.03 per share per quarter. The dividend declared on May 5, 2010, payable on July 15, 2010, was \$0.02 per share relating to the months of May and June.

A quarterly dividend of \$0.03 per share was declared on August 4, 2010, for the quarter ending September 30, 2010 and on November 3, 2010, for the quarter ending December 31, 2010.

After the Conversion there was no substantive change in the ultimate ownership of Pollard. As a result, the Conversion has been accounted for under the continuity of interests method. One consolidated financial statement incorporating the results of both the Fund and Pollard LP has been prepared. Comparative figures have been restated reflecting the combined results of both entities. As the Canadian operations of Pollard are now taxable under the *Income Tax Act* (Canada), the difference between the tax values and the net book value of the Canadian assets and liabilities have been recorded as future tax assets and liabilities in the comparative figures.

The costs related to the Conversion of \$0.7 million were expensed in the second quarter of 2010.

### **Kamloops Facility**

On February 28, 2010, Pollard permanently closed its Kamloops production facility with all related production being transferred to its other facilities. A one-time facility closing accrual of \$4.7 million was expensed in the fourth quarter of 2009, representing the estimated closing costs including employee severance.

As of December 31, 2010, Pollard had expended approximately \$4.3 million of the facility closing reserve.

### **Sale of Kamloops Property**

On June 25, 2010, the building and land formally used in the Kamloops operation was sold to an affiliate of Equities for total proceeds of \$2.9 million resulting in a gain of \$1.8 million. The selling price was based on the current fair market value determined through an independent appraisal.

The following financial information should be read in conjunction with the accompanying financial statements of Pollard and the notes therein as at and for the year ended December 31, 2010.

**SELECTED FINANCIAL INFORMATION**

(millions of dollars, except per share information)

	<b>Year ended</b> <b>December 31, 2010</b>	Year ended December 31, 2009	Year ended December 31, 2008	Year ended December 31, 2007
Sales	<b>\$163.4</b>	\$191.8	\$178.0	\$164.5
Cost of Sales	<b>132.0</b>	153.0	141.1	130.5
Gross Profit	<b>31.4</b>	38.8	36.9	34.0
<i>Gross Profit as a % of sales</i>	<b>19.2%</b>	20.2%	20.7%	20.7%
Selling and Administration Expenses	<b>20.3</b>	21.3	20.4	19.2
<i>Expenses as a % of sales</i>	<b>12.4%</b>	11.1%	11.5%	11.6%
Realized foreign exchange loss (gain)	<b>1.1</b>	4.5	(4.1)	(2.7)
<i>Loss (gain) as a % of sales</i>	<b>0.7%</b>	2.3%	(2.3%)	(1.7%)
Net Income (Loss)	<b>1.7</b>	15.0	(3.4)	20.1
<i>Net Income (Loss) as a % of sales</i>	<b>1.0%</b>	7.8%	(1.9%)	12.2%
Adjusted EBITDA	<b>18.0</b>	21.3	27.9	23.4
<i>EBITDA as a % of sales</i>	<b>11.0%</b>	11.1%	15.7%	14.2%
Earnings (Loss) per share	<b>\$0.07</b>	\$0.64	\$(0.14)	\$0.85
	<b>December 31,</b> <b>2010</b>	December 31, 2009	December 31, 2008	December 31, 2007
Total Assets	<b>\$136.0</b>	\$154.3	\$165.7	\$154.0
Total Long Term Liabilities	<b>\$74.6</b>	\$76.5	\$60.4	\$47.0

The selected financial and operating information has been derived from, and should be read in conjunction with, the consolidated financial statements of Pollard.

## RECONCILIATION OF NET INCOME (LOSS) TO ADJUSTED EBITDA

(millions of dollars)

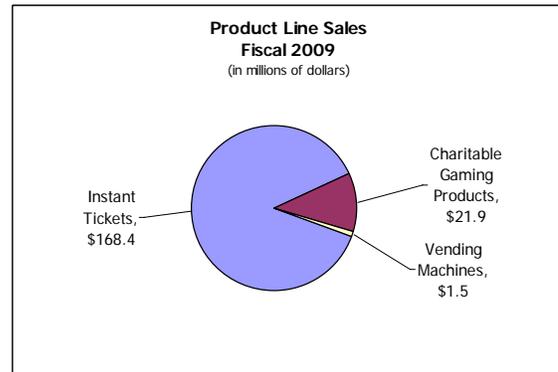
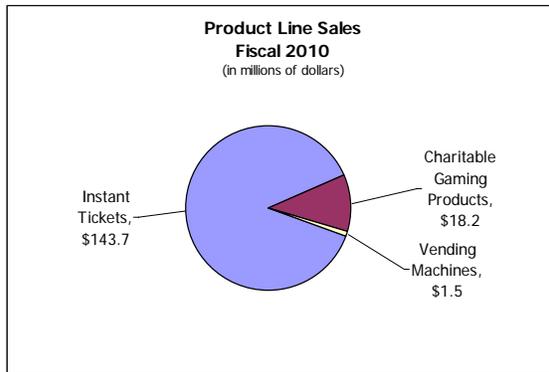
	<b>Year ended December 31, 2010</b>	Year ended December 31, 2009	Year ended December 31, 2008	Year ended December 31, 2007
Net Income (Loss)	<b>\$1.7</b>	\$15.0	\$(3.4)	\$20.1
Adjustments:				
Interest	<b>5.2</b>	4.4	3.8	2.7
Unrealized foreign exchange (gain) loss	<b>(1.2)</b>	(3.6)	4.2	(2.2)
Mark-to-market (gain) loss on foreign currency contracts and interest rate swaps	<b>(2.1)</b>	(10.4)	17.0	(6.3)
Amortization of de-designated hedges	<b>1.2</b>	0.6	-	-
Conversion costs	<b>0.7</b>	-	-	-
Warranty reserve	<b>0.9</b>	-	-	-
Restructuring expense	<b>1.2</b>	-	-	-
Facility closing	-	4.7	-	-
Income taxes (recovery)	<b>1.8</b>	1.7	(1.8)	0.9
Amortization	<b>8.6</b>	8.9	8.4	8.6
Adjusted EBITDA	<b>\$18.0</b>	\$21.3	\$28.2	\$23.8

## REVIEW OF OPERATIONS

Financial and operating information has been derived from, and should be read in conjunction with, the consolidated financial statements of Pollard and the selected financial information disclosed in this MD&A.

## ANALYSIS OF RESULTS FOR THE YEAR ENDED DECEMBER 31, 2010

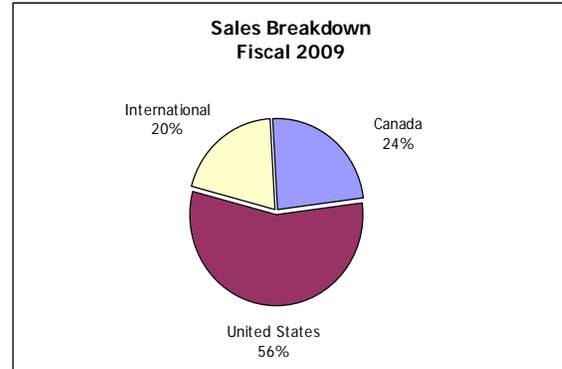
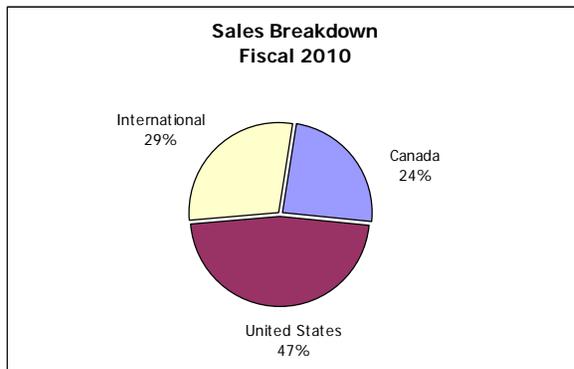
### Sales



During the year ended December 31, 2010 ("Fiscal 2010"), Pollard achieved sales of \$163.4 million, compared to \$191.8 million in the year ended December 31, 2009 ("Fiscal 2009"). Factors impacting the \$28.4 million sales decrease were:

#### *Strengthening of the Canadian dollar*

During Fiscal 2010, Pollard generated approximately 72% of its revenue in U.S. dollars including a significant portion of international sales which are priced in U.S. dollars. During Fiscal 2010 the actual U.S. dollar value was converted to Canadian dollars at \$1.05, compared to a rate of \$1.16 during Fiscal 2009. This decrease in the U.S. dollar value resulted in an approximate decrease of \$12.8 million in revenue relative to Fiscal 2009. Also during Fiscal 2010, the strengthening of the Canadian dollar against the Euro resulted in an approximate decrease of \$1.4 million in revenue relative to Fiscal 2009.



## *Other*

Instant ticket sales volumes for Fiscal 2010 were lower than Fiscal 2009 by 4% which decreased sales by \$7.1 million, in part due to the reduction in capacity with the closure of the Kamloops facility. In addition, a decrease in average selling price compared to 2009 reduced sales by \$5.7 million as a result of an increased mix of lower priced tickets. Charitable Gaming volume decreased slightly during the year reducing sales by \$1.5 million when compared to Fiscal 2009. An increase in vending machine volumes increased sales \$0.1 million when compared to Fiscal 2009.

### **Cost of sales and gross margin**

Cost of sales was \$132.0 million in Fiscal 2010 compared to \$153.0 million in Fiscal 2009. Lower exchange rates on U.S. dollar transactions in Fiscal 2010 decreased cost of sales approximately \$7.0 million. In addition, cost of sales was lower due to lower production volumes, lower costs associated with the mix of production and the impact of cost savings associated with the closure of the Kamloops facility.

Gross profit earned in Fiscal 2010 was \$31.4 million (19.2% of sales) as compared to \$38.8 million (20.2% of sales) earned in Fiscal 2009. This decrease was primarily due to the impact of the stronger Canadian dollar decreasing revenue by a greater amount than the decrease in cost of sales. In addition, gross profit was lower due to the net impact of lower volumes and selling prices, largely offset by the cost savings associated with the closure of the Kamloops facility.

### **Selling and administration expenses**

Selling and administration expenses were \$20.3 million in Fiscal 2010 which is lower than \$21.3 million in Fiscal 2009 due to the impact of certain cost containment strategies. As a percentage of sales, total selling and administration expenses were 12.4% of sales in Fiscal 2010 compared to 11.1% in Fiscal 2009 reflecting the impact of the fixed cost nature of these expenses on lower sales.

### **Foreign exchange gain (loss)**

Foreign exchange gain was \$0.1 million in Fiscal 2010 compared to a loss of \$0.9 million in Fiscal 2009. Within the 2010 foreign exchange gain are unrealized gains of \$1.2 million, relating to a \$1.1 million unrealized foreign exchange gain on U.S. dollar denominated debt (caused by the strengthening of the Canadian dollar between the balance sheets dates of December 31, 2009 and December 31, 2010) and unrealized net gains of \$0.1 million on U.S. dollar denominated receivables and payables. Partially offsetting the unrealized gains are realized losses of \$1.1 million, which is comprised of realized losses on the decreased value of U.S. dollar denominated receivables and the conversion of U.S. dollars and Euros into Canadian dollars.

Within the Fiscal 2009 foreign exchange loss of \$0.9 million was unrealized gains of \$3.6 million relating to the foreign exchange gain on U.S. dollar denominated debt (caused by the strengthening of the Canadian dollar) offset by realized losses of \$4.5 million. The realized losses were comprised of \$3.6 million of realized losses relating to forward hedge contracts (caused by fixed exchange rates in the hedges being lower than actual rates) and \$1.7 million in realized losses on the value of U.S. dollar denominated receivables, partially offset by realized gains on accounts payable of \$0.8 million.

### **Gain on sale of property, plant and equipment**

During Fiscal 2010, Pollard disposed of a building and land in Kamloops, British Columbia to an affiliate of Equities for total proceeds of \$2.9 million resulting in a gain of \$1.8 million. The selling price was based on the current fair market value as determined through an independent appraisal.

During Fiscal 2009, Pollard disposed of a surplus building and land in Winnipeg, Manitoba to an affiliate of Equities for total proceeds of \$3.4 million resulting in a gain of \$1.7 million. The selling price was based on the current fair market value as determined through an independent appraisal.

### **Adjusted EBITDA**

Adjusted EBITDA was \$18.0 million in Fiscal 2010 compared to \$21.3 million in Fiscal 2009. The primary reason for the decrease in Adjusted EBITDA was lower gross margin of \$7.4 million (due primarily to the impact of the strengthening Canadian dollar), partially offset by lower realized foreign exchange losses of \$3.4 million and lower selling and administration costs of \$1.0 million.

### **Interest rate swaps**

A non-cash mark-to-market gain of \$1.3 million was recorded during Fiscal 2010, on interest rate swap contracts no longer designated as hedges, as compared to \$0.6 million in Fiscal 2009. In addition, amortization of \$1.2 million of the previously recorded mark-to-market losses on these interest rate swaps, recorded as accumulated other comprehensive loss, was expensed in Fiscal 2010 as compared to \$0.6 million in Fiscal 2009.

### **Mark-to-market gain on foreign currency contracts**

A non-cash gain of \$0.8 million was recorded in Fiscal 2010, compared to a non-cash gain of \$9.8 million recognized in Fiscal 2009. On March 12, 2010, Pollard sold its remaining foreign currency contracts.

### **Amortization**

Amortization includes amortization of property and equipment and intangible assets and totaled \$8.6 million during Fiscal 2010 which is similar to the \$8.9 million amortized during Fiscal 2009.

### **Interest**

Interest expense increased to \$5.2 million in Fiscal 2010 from \$4.4 million in Fiscal 2009 due primarily to higher interest rates associated with the new syndicated credit facility.

### **Conversion costs**

Conversion expenses of \$0.7 million, primarily legal and accounting fees, were expensed in Fiscal 2010 relating to conversion of Pollard to a publically traded corporation.

### **Warranty reserve**

A warranty reserve adjustment of \$0.9 million was expensed in Fiscal 2010. The warranty reserve relates to product produced in Fiscal 2009 for a specific customer as the originally delivered product no longer met the contractual quality requirements. There is no continuing obligation relating to these products.

### **Restructuring expense**

A restructuring expense of \$1.2 million was incurred in Fiscal 2010. The expense includes approximately \$0.9 million of costs relating to the elimination of approximately 30 salaried positions. In addition, due to changes in the local rules regulating scratch off lottery tickets, our Puerto Rico Lottery operation was restructured to comply with the new rules. Costs incurred of \$0.3 million include the write off of existing inventory and the overhead costs incurred during the transition to the new product line.

### **Employee profit sharing**

Employee profit sharing costs decreased in Fiscal 2010 to \$0.6 million as compared to \$0.9 million in Fiscal 2009 due to reductions in income available for employee profit share. The mark-to-market gains on foreign currency contracts and interest rate swaps, as well as amortization of de-designated hedges and amortization of intangible assets are excluded from the calculation of employee profit sharing.

### **Income taxes**

Income tax expense was \$1.8 million in Fiscal 2010, an effective rate of 51.6%, due to the allocation of partnership losses and distributions to the Limited Partners prior to the Conversion.

Income tax expense was \$1.7 million in Fiscal 2009, an effective rate of 10.3%, as the Canadian operations of Pollard were not taxable in 2009.

### **Net Income**

Net Income decreased to \$1.7 million in Fiscal 2010 from \$15.0 million in Fiscal 2009. The primary reasons for the decline were the decrease in gross profit of \$7.4 million (due primarily to the impact of the strengthening Canadian dollar), the reduction in the non-cash mark-to-market gain on foreign exchange currency contracts and interest rate swaps of \$8.3 million, an increase in interest expense of \$0.8 million, an increase in amortization of de-designated hedges of \$0.6 million, conversion costs of \$0.7 million, warranty reserve of \$0.9 million and restructuring expense of \$1.2 million. These were partially offset by a reduction in foreign exchange loss of \$1.0 million, a decrease in selling and administration costs of \$1.0 million and a reduction in facility closing expense of \$4.7 million.

Earnings per share decreased to \$0.07 per share in Fiscal 2010 from \$0.64 in Fiscal 2009.

## Liquidity and Capital Resources

### *Cash provided by operating activities*

For year ended December 31, 2010, cash flow provided by operating activities was \$6.4 million, compared to cash flow provided by operations of \$14.0 million, for Fiscal 2009.

Changes in the non-cash component of working capital resulted in a decrease in cash flow from operations of (\$1.5) million for the year ended December 31, 2010 compared to an increase of \$5.5 million during the comparable period in 2009. The primary reason for the change between years was the use of cash of (\$3.0) million in reducing accounts payable and accrued liabilities in Fiscal 2010 as compared to cash provided by increasing accounts payable and accrued liabilities of \$4.7 million in Fiscal 2009 due primarily to the accrual of the facility closing reserve in Fiscal 2009 and the subsequent payments incurred in Fiscal 2010.

### *Cash provided by investing activities*

In the year ended December 31, 2010 cash provided by investing activities was consistent with the year ended December 31, 2009, of \$0.6 million. Capital expenditures of (\$2.5) million were incurred in the year ending December 31, 2010, compared to (\$3.6) million for 2009. Cash provided by investing activities included \$3.0 million in proceeds from the sale of property, plant and equipment and \$0.3 million from the change in net investment in leases in the year ended December 31, 2010. For the year ended December 31, 2009, cash provided by investing activities included \$3.4 million and \$1.2 million from the sale of property, plant and equipment and the change in net investment in leases respectively.

### *Cash provided by financing activities*

Cash used by financing activities was (\$5.1) million in the year ended December 31, 2010. Cash provided by financing activities for the year ended December 31, 2009 was \$2.3 million. Dividends decreased to (\$3.7) million in Fiscal 2010 from (\$16.4) million in Fiscal 2009. In Fiscal 2009 an increase in long-term debt generated \$20.6 million in cash.

As at December 31, 2010, Pollard had unused committed debt facility of \$15.3 million. This amount is available to be used for future working capital requirements, contractual obligations, capital expenditures and dividends.

**ANALYSIS OF RESULTS FOR THE PERIOD OCTOBER 1, 2010 TO DECEMBER 31, 2010  
FOURTH QUARTER OF 2010**

**SELECTED FINANCIAL INFORMATION**

(millions of dollars)

	<b>Three months ended December 31, 2010</b>	<b>Three months ended December 31, 2009</b>
	(unaudited)	(unaudited)
Sales	\$37.3	\$46.9
Cost of Sales	29.3	37.1
Gross Profit	8.0	9.8
Expenses (Income):		
Selling and administration	5.3	4.9
Interest	1.1	1.3
Foreign exchange loss	0.4	0.4
Amortization of intangibles	0.5	0.5
Mark-to-market gain on foreign currency contracts and interest rate swaps	-	(1.9)
Amortization of de-designated hedges	-	0.6
Restructuring expense	1.2	-
Facility closing	-	4.7
Other	(0.1)	0.1
Loss before undernoted	(0.4)	(0.8)
Employee profit sharing	0.1	(0.2)
Loss before income taxes	(0.5)	(0.6)
Income taxes:		
Current	0.5	0.4
Future (reduction)	(0.4)	(1.1)
Net Income (Loss)	\$ <u>(0.6)</u>	\$ <u>0.1</u>
Adjustments:		
Interest	1.1	1.3
Unrealized foreign exchange loss (gain)	0.1	(0.6)
Mark-to-market gain on foreign currency contracts and interest rate swaps	-	(1.9)
Amortization of de-designated hedges	-	0.6
Restructuring expense	1.2	-
Facility closing	-	4.7
Income taxes (recovery)	0.1	(0.7)
Amortization	2.2	2.3
Adjusted EBITDA	<u>\$4.1</u>	<u>\$5.8</u>

## **Sales**

During the three months ended December 31, 2010, Pollard achieved sales of \$37.3 million, compared to \$46.9 million in the three months ended December 31, 2009. Factors impacting the \$9.6 million sales decrease were:

### *Strengthening of the Canadian dollar*

During the three months ended December 31, 2010, Pollard generated approximately 75% of its revenue in U.S. dollars including a significant portion of international sales which are priced in U.S. dollars. During the fourth quarter 2010 the actual U.S. dollar value was converted to Canadian dollars at \$1.03, compared to a rate of \$1.08 during the fourth quarter 2009. This decrease in the U.S. dollar value resulted in an approximate decrease of \$2.2 million in revenue relative to the fourth quarter 2009. In addition, during the three months ended December 31, 2010, the strengthening of the Canadian dollar against the Euro resulted in an approximate decrease of \$0.2 million in revenue relative to the three months ended December 31, 2009.

### *Other*

Instant ticket sales volumes for the three months ended December 31, 2010, were lower by 13%, decreasing sales by \$6.5 million. Instant ticket production volumes were consistent with the fourth quarter of 2009; however, the timing of sales relating to a portion of the Fiscal 2010 fourth quarter production will not be recognized until Fiscal 2011 due to the timing of shipments to certain customers and a build up of product for a new contract. A decrease in the average selling price of instant tickets reduced sales by \$1.0 million compared to the fourth quarter of 2009 as a result of a greater mix of lower priced work. Charitable gaming products volumes were higher than the three months ended December 31, 2009 increasing revenues by \$0.1 million; in addition the average price was higher when compared to the fourth quarter of 2009, increasing sales by a further \$0.1 million. An increase in vending machine volumes increased sales \$0.1 million when compared to the three months ending December 31, 2009.

## **Cost of sales and gross margin**

Cost of sales was \$29.3 million in the three months ended December 31, 2010, compared to \$37.1 million in the three months ended December 31, 2009. Lower exchange rates on U.S. dollar transactions in fourth quarter 2010 decreased cost of sales approximately \$0.5 million. In addition, cost of sales were lower due to lower volumes, lower costs associated with the mix of production and the impact of cost savings associated with the closure of the Kamloops facility.

Gross profit was \$8.0 million (21.4% of sales) in the three months ended December 31, 2010, as compared to \$9.8 million (20.9% of sales) in the three months ended December 31, 2009, primarily due to the impact of the strengthening Canadian dollar and the lower instant ticket sales volumes. In addition, gross profit was lower due to the net impact of lower volumes and selling prices, largely offset by the cost savings associated with the closure of the Kamloops facility.

### **Selling and administration expenses**

Selling and administration expenses were \$5.3 million in the three months ended December 31, 2010, which is higher than \$4.9 million in the fourth quarter 2009, as a result of increased travel, personnel and professional costs.

### **Foreign exchange loss**

Foreign exchange loss was \$0.4 million in the three months ended December 31, 2010, similar to a loss of \$0.4 million in 2009. The 2010 foreign exchange loss is comprised of \$0.3 million in realized losses on the write-down of U.S. dollar denominated receivables and \$0.1 million in unrealized losses on adjustment of the Canadian equivalent of U.S. dollar cash balances.

Within the 2009 foreign exchange loss of \$0.4 million was unrealized gains of \$0.6 million relating to the foreign exchange gain on U.S. dollar denominated debt (caused by the strengthening of the Canadian dollar). The unrealized gain was offset by \$1.0 million of realized losses. The realized losses were comprised of \$0.9 million of realized losses relating to forward hedge contracts (caused by fixed exchange rates in the hedges being lower than actual rates) and \$0.3 million in realized losses on U.S. dollar denominated receivables, which were partially offset by \$0.2 million in realized gains on U.S. dollar dominated payables.

### **Adjusted EBITDA**

Adjusted EBITDA was \$4.1 million in the three months ended December 31, 2010, compared to \$5.8 million in the three months ended December 31, 2009. The primary reasons for the decrease in Adjusted EBITDA were lower gross margin of \$1.8 million (due primarily to the impact of the strengthening of the Canadian dollar) and increased selling and administration costs of \$0.4 million. Partially offsetting these items was a decrease in the realized foreign exchange loss of \$0.7 million.

### **Amortization**

Amortization includes amortization of property and equipment and intangible assets and totaled \$2.2 million during the three months ended December 31, 2010, which is similar to the \$2.3 million during the three months ended December 31, 2009.

### **Interest**

Interest expense decreased to \$1.1 million in the fourth quarter 2010 from \$1.3 million in the fourth quarter 2009 due primarily to the elimination of higher interest rates related to certain interest rate swaps which expired on August 31, 2010, partially offset by higher interest rates associated with the new syndicated credit facility.

### **Restructuring expense**

A restructuring expense of \$1.2 million was incurred in the three months ended December 31, 2010. The expense includes approximately \$0.9 million of costs relating to the elimination of approximately 30 salaried positions. In addition, due to changes in the local rules regulating scratch off lottery tickets, our Puerto Rico Lottery operation was restructured to comply with the new rules. Costs incurred of

\$0.3 million include the write off of existing inventory and the overhead costs incurred during the transition to the new product line.

### **Income taxes**

Income tax expense was \$0.1 million in the fourth quarter 2010, an effective rate of (20%), due to withholding taxes and non-deductible expenses.

Income tax recovery was (\$0.7) million in the fourth quarter 2009, an effective rate of 116%, as the Canadian operations of Pollard were not taxable in 2009.

### **Net Income (Loss)**

Net Income (Loss) was (\$0.6) million in the three months ended December 31, 2010, compared to \$0.1 million in the three months ended December 31, 2009. The primary reasons for the decline were lower gross margin of \$1.8 million (due primarily to the impact of the strengthening of the Canadian dollar) and a reduction of the non-cash mark-to-market gain on foreign exchange currency contracts of \$1.3 million, as well as increased selling and administration expenses of \$0.4 million, increased income tax expense of \$0.8 million and the \$1.2 million restructuring expense. Partially offsetting these amounts was the decrease in the expenses related to facility closing in 2009 of \$4.7 million.

The three months ended December 31, 2010 incurred a loss per share of (\$0.03) compared to earnings per share of nil in the three months ended December 31, 2009.

### **Liquidity and Capital Resources**

#### *Cash provided by operating activities*

For the three months ended December 31, 2010, cash flow provided by operating activities was \$7.7 million compared to cash flow provided by operations of \$11.7 million for the comparable period in Fiscal 2009. Changes in the non-cash component of working capital provided an increase in cash flow from operations of \$6.5 million for the three months ended December 31, 2010 (due primarily to reductions in accounts receivable), compared to an increase of \$12.4 million for the three months ended December 31, 2009 (due primarily to reductions in accounts receivables and an increase in facility closing reserve).

#### *Cash provided by investing activities*

In the three months ended December 31, 2010, cash used by investing activities was (\$1.1) million compared to (\$1.3) million used in the fourth quarter of 2009. Capital expenditures of (\$1.1) were incurred in the three months ending December 31, 2010, compared to (\$1.4) million for the three months ending December 31, 2009.

### *Cash provided by financing activities*

Cash used by financing activities was (\$5.4) million in the three months ended December 31, 2010, compared to (\$7.0) million in the three months ended December 31, 2009. The decrease in cash used by financing activities was primarily due to changes in dividends paid and dividends payable.

As at December 31, 2010, Pollard had unused committed debt facility of \$15.3 million. This amount is available to be used for future working capital requirements, contractual obligations, capital expenditures and dividends.

### **Quarterly Information**

(unaudited)

(millions of dollars)

	Q4 2010	Q3 2010	Q2 2010	Q1 2010	Q4 2009	Q3 2009	Q2 2009	Q1 2009
Sales	\$37.3	\$41.7	\$43.2	\$41.2	\$46.9	\$48.4	\$49.5	\$47.0
Adjusted EBITDA	4.1	4.5	5.6	3.8	5.8	6.4	5.1	4.0
Net Income (Loss)	(0.6)	1.5	(0.9)	1.7	0.1	7.7	9.1	(1.9)

Fluctuations in Sales, Adjusted EBITDA, and Net Income (Loss) will vary by quarter depending on the timing of contract awards, changes in customer budgets, ticket inventory levels, lottery retail sales and mark-to-market adjustments to financial instruments.

Sales in 2010 were lower primarily due to the strengthening of the Canadian dollar relative to the U.S. dollar and a decrease in volumes and average selling prices.

Sales in 2009 were higher due to the weaker Canadian dollar over the year relative to the U.S. dollar.

Net Income in Q4 2009 was lower primarily due to the impact of the Kamloops facility closure accrual.

Net Income in Q2 2009 and Q3 2009 was higher primarily due to higher mark-to-market gains on foreign currency contracts. Q2 2009 and Q2 2010 include a gain on sale of property, plant and equipment.

Net Loss in Q1 2009 was incurred primarily due to lower levels of gross profit.

## ***Productive Capacity***

Management has defined productive capacity as the level of operations necessary to maintain an Adjusted EBITDA of \$20.0 million and the current cash flow target of \$13.4 million on an annualized basis. Due to varying factors implicit in the nature of the lottery industry and the instant ticket market, productive capacity can best be measured through a financial output such as Adjusted EBITDA and cash flow. A number of factors impact the level of Adjusted EBITDA including physical plant capacity, machine capacity, nature of product and service offerings produced and mix of customers. Changes to productive capacity since August 5, 2005 (the date of the initial public offering ("IPO")), have occurred primarily through expenditures on fixed assets and improved processes and other internal improvement measures, offset by the impacts of changes in foreign exchange relationships, primarily the strengthening of the Canadian dollar relative to the U.S. dollar and the Euro, and the closure of the Kamloops facility in February 2010. There have been no increases in productive capacity due to acquisitions since August 5, 2005.

Pollard's strategy with respect to productive capacity is to expend the required funds and resources to maintain the assets required to generate the targeted cash flow and Adjusted EBITDA. In addition, dependent on certain market conditions and limitations on available funds, projects are incurred to increase cash inflow or decrease cash outflow. The nature of the lottery industry does not in itself lead to significant obsolescence risk with the operating assets. To grow productive capacity, ongoing investment in new technology, new fixed assets and new intangible assets is required. Pollard utilizes a number of individual strategies to maintain and grow productive capacity including a capital expenditure budget and a rigorous formal approval process, flexible individual customer management relationships and structured maintenance programs throughout all of the facilities.

An important component to managing and growing productive capacity is the management of certain intangible assets, including customer contracts and relationships, patents, computer software and goodwill. Certain of these assets are reflected in Pollard's financial statements due to the use of continuity of interest method of accounting during the transfer of the business August 5, 2005.

Management focuses on maintaining and growing the value of the customer relationship through winning contract renewals, pursuing and obtaining new contracts and assisting existing customers growing their instant ticket product lines. Regular commitment to research and development allows continual development of patents, software and additional technological assets that maintain and increase future distributable cash. Detailed cost benefit analysis is performed for any significant investment of funds or resources in order to minimize the associated risks that these assets will not be able to generate the expected level of cash flow. Where new opportunities are identified, such as a new marketing opportunity or a new machine or process able to reduce input costs, consideration is given to revise plans and take advantage of these prospects.

Certain risks are associated with projects aimed at increasing the productive capacity, including increases in working capital, acquisition or development of intellectual property, development of additional products or services and purchases of fixed assets. If these investments fail to increase Adjusted EBITDA and cash flow, then productive capacity will ultimately decrease over time due to the consumption of these investment resources. The impact on productive capacity may also depend upon the completion and start up timing of certain investment projects.

### ***Working Capital***

Net non-cash working capital varies throughout the year based on the timing of individual sales transactions. The nature of the lottery industry is few individual customers who generally order large dollar value transactions. As such, the change in timing of a few individual orders can impact significantly the amount required to be invested in inventory or receivables at a particular period end. The high value, low volume of transactions results in some significant volatility in non-cash working capital, particularly during a period of rising volumes or new contract initiation. Similarly, the timing of the completion of the sales cycle through collection can significantly impact non-cash working capital.

Instant tickets are produced specifically for individual clients resulting in a limited investment in finished goods inventory. Customers are predominantly government agencies, which result in regular payments. These factors assist in a reasonably quick turnover in net working capital. There are a limited number of individual customers, and therefore net investment in working capital is managed on an individual customer by customer basis, without the need for company wide benchmarks.

The overall impact of seasonality does not have a material impact on the carrying amounts in working capital.

	December 31, 2010	December 31, 2009
Working Capital	\$26.1	\$25.9
Total Assets	\$136.0	\$154.3
Total Long Term Liabilities	\$74.6	\$76.5

### ***Credit Facility***

Pollard's credit facility, which was renewed effective September 30, 2010, consists of one committed term bank loan facility. The committed term bank loan facility provides loans of up to \$70.0 million for its Canadian operations and up to US\$25.0 million for its U.S. subsidiaries. Borrowings under the credit facility bear interest at fixed and floating rates based on Canadian and U.S. prime bank rates, banker's acceptances or LIBOR. At December 31, 2010, the outstanding letters of guarantee were \$4.7 million and the remaining balance available for drawdown was \$15.3 million.

Under the terms and conditions of the credit facility agreement Pollard is required to maintain financial covenants including working capital ratios, debt to income before interest, income taxes, depreciation and amortization ("Adjusted EBITDA") ratios and certain debt service coverage ratios. Under the syndicated credit facility, Pollard has agreed not to pay dividends in excess of the current quarterly amount of \$0.03 per share until the debt to Adjusted EBITDA ratio is reduced to a certain level. As at December 31, 2010 and March 9, 2011, Pollard is in compliance with all covenants.

Pollard's credit facility is secured by a first security interest in all of the present and after acquired property of Pollard and its operating subsidiaries. The credit facility can be prepaid without penalties. Under the terms of the agreement, the credit facility is committed for a one year period, renewable October 31, 2011. If the credit facility is not renewed, the loans are repayable one year after the credit facility expiry date. As such, the credit facility has effectively a two year term expiring October 31, 2012.

Under the credit facility, Pollard is required to repay principal payments on a quarterly basis, beginning July 1, 2011, of an amount to be calculated based on 50% of the prior quarter's Free Cash Flow. Free Cash Flow is defined as Adjusted EBITDA less interest and current income taxes. The requirement to repay certain principal amounts is waived when the debt to Adjusted EBITDA ratio reaches certain target levels.

As at December 31, 2010, a Pollard subsidiary had entered into an interest rate swap contract to fix the interest rates on approximately 20% of the long-term debt for a period of eight months. The interest rate swap allows the subsidiary to receive interest at floating rates and pay interest at a fixed rate.

Pollard believes that its credit facility and ongoing cash flow from operations will be sufficient to allow it to meet ongoing requirements for investment in capital expenditures, working capital and dividends at existing business levels.

### ***Outstanding Share Data***

As at December 31, 2010 and March 9, 2011, outstanding share data was as follows:

Common shares	23,543,158
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### **Contractual Obligations**

Pollard's subsidiaries rent premises and equipment under long-term operating leases. The following is a schedule by year of commitments and contractual obligations outstanding:

(millions of dollars)	Total	<1 Year	1-3 Years	4 – 5 Years	Thereafter
Long-term debt	\$74.0	-	\$74.0	-	-
Other long-term liabilities	\$0.8	-	\$0.8	-	-
Interest on long-term debt <sup>(1)</sup>	\$7.7	\$4.4	\$3.3	-	-
Operating leases	\$27.8	\$3.1	\$8.5	\$5.5	\$10.7
Total	\$110.3	\$7.5	\$86.6	\$5.5	\$10.7

<sup>(1)</sup> Interest on long-term debt includes interest related to the interest rate swap agreement.

### **Pension Obligations**

Pollard sponsors four non-contributory defined benefit pension plans, of which three are final pay plans and one is a flat benefit plan. As of December 31, 2010, the aggregate fair value of the assets of Pollard's defined benefit pension plans was \$21.9 million and the accrued benefit plan obligations were \$22.0 million. Pollard's total annual funding contribution for all pension plans in 2011 is expected to be approximately \$2.9 million, compared to \$2.9 million in 2010, so long as long-term expectations of fund performance for the defined benefit plans are met.

## **Off-Balance Sheet Arrangements**

Other than the operating leases described previously, Pollard has no other off-balance sheet arrangements.

## **Related Party Transactions**

During the year, Pollard Equities Limited paid Pollard \$0.07 million (2009 – \$0.07 million) for accounting and administration fees.

During the year ended December 31, 2010, Pollard paid property rent of \$2.7 million (2009 - \$2.0 million) and \$0.1 million (2009 – nil) in plane charter costs to affiliates of Equities.

Also during the year, Pollard sold the building and land formally used in the Kamloops operation to an affiliate of Equities for total proceeds of \$2.9 million resulting in a gain of \$1.8 million. The selling price was based on the current fair market value determined through an independent appraisal. During Fiscal 2009, Pollard disposed of a surplus office building and land in Winnipeg, Manitoba to an affiliate of Equities for total proceeds of \$3.4 million resulting in a gain of \$1.7 million. The selling price was based on the current fair market value as determined through an independent appraisal.

Pollard has leased a building in Council Bluffs, Iowa from an affiliate of Equities for a ten year term, ending December 31, 2018, with annual lease payments of US\$0.264 million.

A manufacturing facility in Winnipeg, Manitoba is leased from an affiliate of Equities for a 12 year 6 month period, ending March 31, 2021, at an annual base rate of approximately \$2.4 million.

At December 31, 2010, Pollard owes Equities and its affiliates \$0.7 million (2009 - \$0.3 million) for rent and other expenses.

Also included in accounts payable and accrued liabilities is an amount owing to Equities of \$0.5 million. According to the terms of the Investment Agreement dated July 27, 2005, Equities agreed to indemnify Pollard for all costs relating to certain outstanding litigation at the time of the IPO, including litigation relating to the closure of Imprimerie Spéciale de Banque (ISB), a French subsidiary of the predecessor company to Pollard which ceased operations as of November 15, 1999. The indemnity was subject to an overriding requirement for Pollard to absorb the first \$0.5 million of any indemnified costs. The litigation relating to ISB was settled in 2009 by Equities for \$1.8 million and as such, Pollard is required to reimburse \$0.5 million to Equities. The \$0.5 million liability was originally accrued at the time of the August 5, 2005, IPO as Pollard's expected share of the liability related to the ISB litigation.

## **Critical Accounting Policies and Estimates**

The preparation of the financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting period. Management of Pollard regularly reviews its estimates and assumptions based on historical experience and various other assumptions that it believes would result in reasonable estimates given the circumstances. Actual results could differ from those estimates under different assumptions. The following is a discussion of accounting policies which require significant management judgment and estimation.

## ***Goodwill***

Goodwill represents the excess of the purchase price over the fair value of the net assets acquired of Pollard's U.S. subsidiaries and the excess purchase price over the underlying carrying amount of the portion of the net assets sold as at August 5, 2005, as part of the 26.7% of Pollard sold in conjunction with the IPO, and is not amortized. Goodwill is subject to an annual impairment review to ensure its fair value remains greater than, or equal to, book value.

The impairment test is carried out in two steps. In the first step, the carrying amount of the reporting unit is compared with its fair value. When the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not to be impaired and the second step of the impairment test is unnecessary. The second step is carried out when the carrying amount of a reporting unit exceeds its fair value, in which case the implied fair value of the reporting unit's goodwill is compared with its carrying amount to measure the amount of the impairment loss, if any. The implied fair value of goodwill is determined in the same manner as the value of goodwill is determined, using the fair value of the reporting unit as if it was the purchase price. When the carrying amount of the reporting unit's goodwill exceeds the implied fair value of the goodwill, an impairment loss is recognized. Pollard performed the impairment tests and the goodwill has been found to not be impaired.

## ***Financial instruments***

Pollard may use certain derivative financial instruments to manage risks of fluctuation in interest rates and foreign exchange rates. Pollard does not engage in the trading of these derivative financial instruments for profit.

Pollard's subsidiaries may enter into interest rate swap agreements in order to limit exposure to increases in interest rates and fix interest rates on certain portions of long-term debt. Pollard applies hedge accounting for certain interest rate swap agreements that meet the criteria for hedge accounting. The effective portion of the gain or loss on the hedging item is recognized in other comprehensive income and any ineffective portion is recognized in Net Income. Payments and receipts under interest rate swap agreements designated as effective hedges are recognized as adjustments to interest expense on long-term debt in the same period that the underlying hedged transactions are recognized. Pollard formally documents the relationship between the hedging instrument and the hedged item, as well as the nature of the specific risk exposure being hedged and the intended term of the hedging relationship. The effectiveness of the hedge is assessed at inception and throughout the term of the hedge. Any hedging transactions that do not qualify for hedge accounting are marked-to-market at each period end with any resulting gains or losses recorded in income.

Pollard's subsidiaries may enter into foreign currency forward contracts to limit exposure on certain recognized assets or liabilities, firm commitments or foreign currency risk in an unrecognized firm commitment. The foreign currency contracts are recognized in the balance sheet and measured at fair value, with changes in fair value recognized currently in the statement of income.

### ***Income taxes***

Pollard's incorporated subsidiaries are taxable entities and as such, income taxes are recorded to reflect the expected future tax consequences of temporary differences between the carrying amounts of assets and liabilities and their tax basis. Future income tax assets and liabilities are determined based on the enacted or substantively enacted tax rates, which are expected to be in effect when the underlying items of income and expense are expected to be realized. Valuation allowances are established when necessary to reduce the future tax assets to the amounts expected to be realized. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment.

### ***Leases***

In some instances, one of Pollard's subsidiaries will lease vending machines to third-party customers. Depending on the specific terms contained in the lease agreements, the lease is either classified as an operating lease or capitalized as a sales-type lease.

Pollard's subsidiary's leasing operations consist principally of the leasing of Pull-tab Vending Machines (PTVM) with various private establishments. These leases are classified as sales-type leases. The PTVM leases have three year terms. The net investment in sales-type leases consists of the present value of the future minimum lease payments. Interest revenue is recognized as a constant percentage return on the net investment.

### **Future Changes in Accounting Policies**

#### **International Financial Reporting Standards**

In January 2006, the Accounting Standards Board of Canada ("AcSB") announced that accounting standards in Canada are to converge with the International Financial Reporting Standards ("IFRS"). Canadian publicly accountable enterprises must adopt IFRS for their interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011.

Pollard established a four part planning framework in 2008 to ensure an effective and efficient transition regarding the introduction of International Financial Reporting Standards ("IFRS") in 2011:

<b>Step</b>	<b>Timing</b>
1. Scoping the Effort	(completed 2008)
2. Enabling the Resources	(completed 2010)
3. Executing the Plan	(Q3 2009 - Q1 2011)
4. Monitoring the Process	(2008 - 2011)

Step 1 and 2 have been completed. Steps 3 and 4 are currently ongoing. All detailed execution steps continue to be consistent with the times identified in the planning framework.

## 1. Scoping the Effort

A project team was identified utilizing both internal resources and where necessary, external resources. Formal timelines were established and appropriate training was received by all team members including participation in a number of externally led in-depth programs, ongoing formal review of updates and regularly scheduled meetings to confirm ongoing status.

## 2. Enabling the Resources

A review was undertaken of current accounting policies in comparison to the standards under IFRS. Differences were identified and documented, with those applicable to Pollard specifically reviewed to determine changes required and impact on current financial disclosure, systems and business activities.

## 3. Executing the Plan

Based on the differences identified in step #2, specific analysis was prepared identifying the preliminary recommended accounting policies (where choices are required) and analysis began to calculate the impact of on the opening transition balance sheet as at January 1, 2010. Detailed seminars were held with senior executives of Pollard and the Audit Committee to review the recommendations relating to accounting policy choices and impact on other areas throughout the process.

## 4. Monitoring the Process

Detailed quarterly updates have been prepared and presented to the Board of Directors and the Audit Committee of Pollard. Regular meetings are held to review the status of the transition plan and these will continue throughout 2011.

The IFRS transition plan covers five main areas of Pollard's operations.

### **A Accounting Policies**

Pollard has completed its analysis of the accounting differences arising on conversion to IFRS and has preliminarily quantified the estimated impact to the January 1, 2010 opening balance sheet, as further described below. Pollard is in the process of determining the impact on earnings for the year ended December 31, 2010. In addition to the accounting policy changes described below, Pollard expects to make changes to financial statement presentation and disclosure, and is in the process of preparing draft financial statements reflecting the additional disclosures required under IFRS. The information below is based on our current views, assumptions and expectations. However, circumstances may arise, such as changes in IFRS standards or interpretations of existing IFRS standards, which could result in further adjustments upon our transition to IFRS. This analysis is based on the IFRS standards expected to be in effect at the end of the first IFRS reporting year ending December 31, 2011, and Pollard will continue to monitor changing standards to assess their impact for 2011 and in future periods.

#### 1. Future Accounting Policy Choices

Significant future accounting policy alternatives under IFRS have been reviewed. Recommendations, where choices are required, have been identified by management and approved by the Audit Committee.

## 2. Mandatory and Optional Exemptions

IFRS 1 identifies certain voluntary and mandatory exemptions from adopting IFRS policies at transition date. Management has identified the optional exemptions to be utilized by Pollard and these have been approved by the Audit Committee.

For a summary of Pollard's future accounting policies and optional exemptions under IFRS 1 please see the following chart on page 27.

### **B Internal Controls over Financial Reporting**

Upon finalization of the accounting policy choices on transition and the required disclosures, any necessary changes will be implemented to the internal controls over financial reporting ("ICFR"). Pollard is currently reviewing and preparing the disclosures required under IFRS for the first quarter 2011 financial statements. Appropriate review and testing of any new or changed controls will also occur during this time frame.

Based on our preliminary estimate of the impact of the new accounting and disclosure standards not being significant, management does not expect impact on the ICFR to be significant and will focus on the key environment controls and management review and involvement to ensure the transition to IFRS is appropriately controlled.

### **C Disclosure Controls and Procedures**

Pollard ensures its key stakeholders are informed about the anticipated effects of the IFRS transition including disclosure in our MD&A and will complete any further necessary changes to our disclosure control procedures during the first quarter 2011.

### **D Information Systems**

Our general ledger and financial reporting system is currently structured to allow for IFRS implementation without significant changes. The current fixed asset system allows for detailed component analysis to be tracked separately. No other major systems are expected to need significant changes.

### **E Business Activities**

A review of business related activities was undertaken during the scoping phase to identify issues that need to be addressed due to the transition to IFRS. The syndicated credit facility completed effective September 30, 2010, includes an allowance to reflect any potential impact based on IFRS adjustments.

### **IFRS 1 – First-time Adoption of IFRS and Future Accounting Policy Changes**

The initial adoption of IFRS has required Pollard to review each of its accounting policies and determine whether or not a change is required or permitted under IFRS and whether any amended policy is required to be applied on a retrospective or prospective basis. IFRS 1 generally requires retrospective application of the new policies but prospective application is required or permitted in some instances.

The below table is a high-level summary of the significant accounting policies of Pollard and the impact of adopting the new standards under IFRS including exemptions under IFRS 1. New standards under IFRS 1 that do not apply to Pollard have not been listed.

Accounting Policy	Policy change expected on transition to IFRSs	Is there an IFRS 1 exemption available?	Will the IFRS 1 exemption be applied?
<b>ELECTIVE EXEMPTIONS</b>			
Business Combinations	Yes	Yes	Yes
Fair Value or Revaluation as deemed Cost – Property, Plant and Equipment	No	Yes	No
Borrowing Costs	Yes	Yes	Yes
Employee Benefits – Actuarial Gains and Losses	Yes	Yes	Yes
Employee Benefit Plans – Defined Benefit Plans Disclosures	Yes	Yes	Yes
Cumulative Translation Differences	Yes	Yes	Yes

### **Business Combinations**

IFRS 3 will be applied prospectively in the opening IRFS statement of financial position and prior business combinations will not be restated due to Pollard choosing to apply the IFRS 1 exemption for business combinations prior to January 1, 2010. As required by the prospective application requirements relating to IFRS 3, Pollard has determined its cash generated units (“CGU’s”) and allocated its goodwill accordingly. Pollard has tested its goodwill for impairment in accordance with IFRS at the date of transition, January 1, 2010, and determined that there is no impairment.

### **Property, Plant and Equipment**

Under the requirements of International Accounting Standard (“IAS”) 16, the company will continue to account for all property, plant and equipment (“PP&E”) under the cost model. There are options available under the new standard to account for PP&E on a fair market value basis.

Under IFRS 1 there is an exemption available whereby an organization can elect at its opening transitional balance sheet to revalue some or all of its PP&E on a fair market value basis rather than cost. Pollard will not be electing this exemption.

IAS 16 also requires that assets be depreciated at the significant parts level. Pollard has finalized its categorization and recalculated the impact of restating depreciation on this basis.

At of the transition date, January 1, 2010, the estimated impact of this adjustment will reduce PP&E by \$1.0 million, retained earnings by \$0.8 million and increase future income tax assets by \$0.2 million.

### **Borrowing Costs**

Under IAS 27 companies are required to capitalize borrowing costs directly attributable to acquisitions or construction activities under certain circumstances. Historically Pollard has not capitalized borrowing costs and after adoption of IFRS will be required to prospectively capitalize borrowing costs for qualifying assets. Pollard will elect the IFRS 1 exemption and not retrospectively restate our financials to reflect the capitalization of borrowing costs.

### **Employee Benefits – Actuarial Gains and Losses**

Under adoption of IFRS 1 companies have the choice to recognize all cumulative unrecognized Actuarial Gains and Losses (“AGL”) at the date of transition. Pollard will be electing this exemption and will be recognizing retrospectively the cumulative unrecognized AGL in retained earnings at time of transition. The estimated impact of this election on the opening transitional balance sheet is a reduction of prepaid expenses and deposits of \$1.3 million, an net increase in future income tax assets of \$0.3 million and a decrease in retained earnings of \$1.0 million.

Companies also currently have the option to account for prospective AGL’s using a variety of methods including full recognition in income or recognizing over a period of time utilizing the corridor method. Pollard will continue to use the corridor method, which recognizes AGL’s into income over a period of time only if the absolute amount exceeds a certain level relative to the assets and liabilities of the pension plan. Under Canadian GAAP Pollard currently also follows the corridor method.

### **Employee Benefit Plans – Defined Benefit Plans Disclosures**

Under IFRS 1 a company can elect not to provide the extensive historical disclosures required under IAS 19. Pollard will elect the exemption to exclude the extensive disclosure on transition.

### **Cumulative Translation Differences**

Under IFRS 1 a first-time adopter can elect not to restate and recalculate the Cumulative Translation Differences (“CTA”) in accordance with the new standard. If an adopter uses this exemption the CTA difference is deemed to be zero at the transition date. Pollard will elect to utilize this exemption and the CTA related to translations differences will be deemed to be zero. As a result, the estimated reduction of retained earnings and increase to accumulated other comprehensive income, at January 1, 2010, is \$2.2 million.

### **Future Income Taxes**

Under IAS 12 a company is required to tax effect the difference between historical foreign exchange rates used to convert a company’s foreign currency denominated PP&E and the current rate at the date of the financial statements. The estimated impact to the January 1, 2010 balance sheet is a reduction of \$0.6 million in the future income tax assets and retained earnings.

## **Impact of Trust Conversion**

As described earlier in this MD&A, Pollard Banknote Income Fund converted to a publicly traded corporation during 2010 and accounted for the Conversion under Canadian GAAP under the continuity of interests method. IFRS does not have any explicit guidance that prescribes this method. However, based on an analysis of IFRS guidance applicable to business combinations involving entities under common control, Pollard has concluded that the Conversion would also be accounted for on a book value basis under IFRS, and that it is permissible to restate its comparatives as if the combination had occurred prior to the start of the earliest period presented. As a result, Pollard's IFRS transition date opening balance sheet will be based on its restated Canadian GAAP balance sheet and there will be no adjustments required under IFRS as a result of the Conversion in 2010.

## **Impact on Fiscal 2010**

Under the transition to IFRS, Pollard estimates the only significant adjustment to Net Income for the year ended December 31, 2010 is an increase of \$0.1 million in future income tax assets and a decrease of future income tax expense of \$0.1 million, relating to the future income taxes calculated on the difference between the historical exchange rates used to convert foreign currency denominated PP&E and the current rate at December 31, 2010.

## **Industry Risks and Uncertainties**

Pollard is exposed to a variety of business and industry risks. A summary of the major risks faced by Pollard is noted below.

### ***Dependence on Key Products***

Instant lottery tickets and related services accounted for approximately 88% of Pollard's Fiscal 2010 revenues. Pollard's financial results and condition are substantially dependent on the continued success and growth in sales of this product and the profitability of such sales. Competitive efforts by other manufacturers of similar or substitute products, shifts in consumer preferences or the introduction and acceptance of alternative product offerings could have a material adverse effect on Pollard's business, financial condition, liquidity and results of operations.

### ***Economic Uncertainty***

Considerable economic uncertainty and concern over possible recessions and economic downturns have dominated the news in the past 24 months. Instant lottery tickets account for approximately 88% of revenue and Pollard's financial results and condition are substantially dependent on the continued success and growth in sales of this product and the profitability of such sales. Historically the lottery industry, and particularly the instant ticket product lines, has not shown any significant negative impact during downturns in the economic cycles. At the present time Pollard foresees minimal impact on its operations or product demand due to the current uncertainty and volatility in the economic landscape. However, lotteries, similar to many government agencies, are increasingly under pressure to reduce costs and expenditures. As such, Pollard has witnessed downward pressure on its selling prices. Continued pressure on lotteries to reduce their costs may further negatively impact Pollard's selling prices. Significant shifts in consumer preferences or the introduction and acceptance of alternative product offerings could have a material adverse effect on Pollard's business, financial condition, liquidity and results of operations.

### ***Inability to Sustain Sales or EBITDA Margins***

Pollard's income depends upon its ability to generate sales to customers and to sustain its EBITDA margins. These margins are dependent upon Pollard's ability to continue to profitably sell lottery tickets and gaming products and to continue to provide products and services that make it the supplier of choice to its customers. If Pollard's costs of goods or operating costs increase, or other manufacturers of gaming products could compete more favourably with it, Pollard may not be able to sustain its level of sales or EBITDA margins.

### ***Dependence on Major Customers***

Pollard's 10 largest customers accounted for approximately 56% of its revenue during Fiscal 2010. Pollard's largest customer accounted for 11% of Pollard's revenues during Fiscal 2010. The nature of the worldwide lottery industry limits the absolute number of lottery operations. As is customary in the industry, Pollard does have long-term contracts with most of its customers. However, most allow the customer to cancel the contract at will and none guarantee volumes or order levels. A significant reduction of purchases by any of Pollard's largest customers could have a material adverse effect on Pollard's business, financial condition, liquidity and results of operations including the amount of cash available for dividends to shareholders.

### ***Exchange Rate Fluctuation***

A significant portion of Pollard's revenues and expenses, principally related to its U.S. operations and to the purchase of raw materials, are denominated in U.S. dollars. Furthermore, although certain raw materials may be purchased in Canadian dollars, they may have inputs that are denominated in foreign currencies. Any changes in the exchange rate between the Canadian dollar and these foreign currencies could have a material effect on the results of Pollard.

For the purposes of financial reporting, any change in the value of the Canadian dollar against the U.S. dollar during a given financial reporting period would result in a foreign exchange loss or gain on the translation of any U.S. dollar monetary assets and liabilities. Further, Pollard's reported earnings could fluctuate materially as a result of revenues and expenses denominated in U.S. dollars under Canadian GAAP. There can be no assurance that changes in the currency exchange rate will not have a material adverse effect on Pollard or on its ability to maintain a consistent level of dividends in Canadian dollars.

### ***Additional Capital Requirements***

Pollard believes that its future operating income will be sufficient to fund operations and planned capital expenditures. However, Pollard may be required to raise additional capital in the future if it decides to make additional acquisitions or significant additional capital expenditures.

The availability of future borrowings and access to capital markets for longer-term future financing depends on prevailing conditions and the acceptability of financing terms offered. There can be no assurances that future borrowings or equity financing will be available or available on acceptable terms.

## ***Competition***

The instant ticket and charitable gaming business is highly competitive, and Pollard faces competition from a number of domestic and foreign instant ticket manufacturers and other competitors. Pollard currently has two instant ticket competitors in North America: Scientific Games Corporation and Gtech Printing Corporation. Charitable gaming competitors include a number of manufacturers such as Arrow International, Inc., International Gamco, Inc. and Universal Manufacturing, Inc. Internationally, there are a number of lottery instant ticket vendors which compete with Pollard including Scientific Games, Gtech, and the Eagle Press Group of Companies.

Some of Pollard's competitors have longer operating histories, greater name recognition, larger customer bases and greater financial, technical and marketing resources than Pollard. These resources may allow them to respond more quickly than Pollard can to new or emerging technologies and to changes in customer requirements. It may also allow them to devote greater resources than Pollard can to the development, promotion and sale of their products. Pollard's competitors may also engage in more extensive research and development, undertake more far-reaching marketing campaigns and adopt more aggressive pricing policies. The market for Pollard's products is highly competitive at both the lottery and charitable gaming levels. Pollard expects competition to continue to be intense because of capacity in its markets. Pollard also faces competition from emerging and existing lottery and charitable gaming products, such as internet gaming products and video lottery terminals. Competition from these and other gaming products may weaken demand for Pollard's products.

## ***Licensing and Regulatory Requirements***

Pollard is subject to regulation in most jurisdictions in which its products are sold or used by persons or entities licensed to conduct gaming activities. The gaming regulatory requirements vary from jurisdiction to jurisdiction and licensing, other approval or finding of suitability processes with respect to Pollard, its personnel and its products, can be lengthy and expensive. Many jurisdictions have comprehensive licensing, reporting and operating requirements with respect to the sale and manufacture of bingo and bingo related products, including bingo paper and pull-tab tickets. These licensing requirements have a direct impact on the conduct of the day-to-day operations of Pollard. Generally, gaming regulatory authorities may deny applications for licenses, other approvals or findings of suitability for any cause they may deem reasonable. There can be no assurance that Pollard, its products or its personnel will receive or be able to maintain any necessary gaming licenses, other approvals or findings of suitability. The loss of a license in a particular jurisdiction will prohibit Pollard from selling products in that jurisdiction and may prohibit Pollard from selling its products in other jurisdictions. The loss of one or more licenses held by Pollard could have an adverse effect on the business.

Certain jurisdictions require extensive personal and financial disclosure and background checks from persons and entities beneficially owning a specific percentage (typically five percent or more) of a vendor's securities. The failure of beneficial owners of Pollard's securities to submit to background checks and provide such disclosure could result in the imposition of penalties upon these beneficial owners and could jeopardize the award of a lottery contract to Pollard or provide grounds for termination of an existing lottery contract.

### ***Income and Other Taxes***

Pollard's incorporated subsidiaries are subject to Canadian federal and provincial, and U.S. federal, state and withholding taxes. As taxing regimes change their tax basis and rates or initiate reviews of prior tax returns, Pollard could be exposed to increased costs of taxation, which would reduce the amount of funds available for operations.

### ***Intellectual Property***

Pollard's commercial success depends, in part, on its ability to secure and protect intellectual property rights that are important to its business, including patent, trademark, copyright and trade secret rights, to operate without infringing third party intellectual property rights and to avoid having third parties circumvent the intellectual property rights that Pollard owns or licenses. In particular, the patents and trademarks Pollard owns or licenses may not be valid or enforceable. In addition, Pollard cannot be certain that its proprietary technology affords a competitive advantage, does not infringe third party rights, or will not need to be altered in response to competing technologies. Pollard also cannot be certain that technologies developed in the future will be the subject of valid and enforceable intellectual property rights.

In addition, litigation may be necessary to determine the scope, enforceability and validity of third party intellectual property rights or to establish Pollard's intellectual property rights. Regardless of merit, any such litigation could be time consuming and expensive, divert management's time and attention, subject Pollard to significant liabilities, require Pollard to enter into costly royalty or licensing agreements, or require Pollard to modify or stop using intellectual property that it owns or licenses.

### ***Interest Rates***

Pollard has certain floating rate loans and may be negatively impacted by increases in interest rates, the effects of which would be to reduce net income and the amount of cash available for operations.

Pollard has in place hedging arrangements to mitigate a portion of interest rate fluctuation risk, but there can be no assurance that changes in interest rates will not have a material adverse effect on Pollard or on its ability to maintain a consistent level of dividends in Canadian dollars.

### ***Future Acquisition and Integration Risks***

To grow by acquisition, Pollard must identify and acquire suitable acquisition candidates at attractive prices and successfully integrate any acquired businesses with its existing operations. If the expected synergies from acquisitions do not materialize or Pollard fails to successfully integrate any new businesses into its existing business, Pollard's financial performance could be significantly impacted. To the extent that businesses acquired by Pollard or their prior owners failed to comply with or otherwise violated applicable laws, Pollard, as a successor owner, may be financially responsible for these violations.

In connection with future acquisitions by Pollard, there may be liabilities that Pollard failed or was unable to discover in its due diligence prior to the consummation of the acquisition. The discovery of any material liabilities could have a material adverse effect on Pollard's business, financial condition, liquidity and results of operations or future prospects.

## **Financial Instruments**

Pollard is exposed to financial risks that arise from fluctuations in interest rates and foreign exchange rates and the degree of volatility of these rates, liquidity risk and credit risk. Pollard uses financial instruments, from time to time, to manage these risks.

Pollard's risk management policies are established to identify and analyze the risks, to set appropriate risk limits and controls to monitor risks and adherence to limits. The Audit Committee oversees how management monitors compliance with Pollard's risk management policies and procedures. The Audit Committee is assisted in its oversight role by Internal Audit, who undertakes regular reviews of risk management controls and utilizes the annual risk assessment process as the basis for the annual audit plan.

### ***Risk Exposure***

#### Currency risk

Pollard sells a significant portion of its products and services to customers in the United States and to international customers where sales are denominated in U.S. dollars. In addition, a significant portion of its cost inputs are denominated in U.S. dollars. Pollard also generates a small amount of revenue in currencies other than Canadian and U.S. dollars, primarily in Euros.

In addition, translation differences arise when foreign currency monetary assets and liabilities are translated at foreign exchange rates that change over time.

#### Interest rate risk

Pollard is exposed to interest rate risk relating to its fixed and floating rate instruments. Fluctuation in interest rates will have an effect on the valuation and repayment of these instruments.

#### Credit risk

Credit risk is the risk of financial loss if a customer or counterpart to a financial instrument fails to meet its financial obligations.

#### Liquidity risk

Liquidity risk is the risk that Pollard will not be able to meet its financial obligations as they fall due.

### ***Risk Management***

#### Currency risk

Pollard utilizes a number of tools to manage its foreign currency risk including sourcing its manufacturing facilities in the U.S. and sourcing other cost of goods sold in U.S. dollars.

Two manufacturing facilities are located in the U.S. and a significant amount of cost inputs for all production facilities are denominated in U.S. dollars, offsetting a large portion of the U.S. dollar revenue in a natural hedge.

Pollard also has the ability to utilize various financial instruments to hedge U.S. dollar exposure including the use of foreign currency forward contracts. As at December 31, 2010, Pollard has no contracts outstanding.

A 50 basis point strengthening/weakening in the foreign exchange rate between the Canadian and U.S. dollar would decrease/increase the income before income taxes by \$0.2 million for the year ended December 31, 2010.

As at December 31, 2010, the amount of financial liabilities denominated in U.S. dollars exceeds the amount of financial assets denominated in U.S. dollars by approximately \$14.0 million. A 50 basis point weakening/strengthening in the value of the Canadian dollar relative to the U.S. dollar would result in a decrease/increase in Net Income of approximately \$0.07 million.

#### Interest rate risk

Pollard utilizes interest rate swaps to mitigate these risks by hedging a portion of long-term debt. As at December 31, 2010, one of Pollard's subsidiaries has entered into an interest rate swap contract to fix the interest rates on approximately 20 percent of the long-term debt for a period of 8 months. This interest rate swap contract allows one of Pollard's subsidiaries to receive interest at floating rates and pay interest at a fixed rate.

Pollard Holdings, Inc., a subsidiary, entered into one interest rate swap agreement effectively converting variable rate debt obligations in the amount of US\$14.8 million with underlying current floating rates of 0.56 percent plus applicable credit margin to a fixed rate of 2.95 percent plus applicable credit margin from August 31, 2010 to August 31, 2011.

A 50 basis point decrease/increase in interest rates would result in an increase/decrease in income before income taxes of \$0.3 million for the year ended December 31, 2010.

#### Credit risk

Credit risk on Pollard's accounts receivable is minimized since they are mainly from governments and their agencies and are collected in a relatively short period of time. Credit risk on Pollard's net investment in leases is minimized since they are dispersed among a large, diversified group of customers. Credit risk on foreign currency and interest rate swap contracts is minimized since the counterparties are restricted to Schedule 1 Canadian financial institutions.

The carrying amount of accounts receivable is reduced through the use of an allowance account and any adjustment to the allowance account is recognized in the statement of income within selling and administration expense. When a receivable balance is considered uncollectible, it is written off against the allowance account.

## Liquidity risk

Pollard's approach is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due. Pollard maintains a committed credit facility including up to \$70.0 million for its Canadian operations and up to US\$25.0 million for its U.S. subsidiaries. At December 31, 2010, the unused balance available for drawdown was \$15.3 million.

The 2011 requirements for capital expenditures, working capital and dividends are expected to be financed from cash flow provided by operating activities and unused credit facility. Pollard enters into contractual obligations in the normal course of business operations.

## **Outlook**

The instant lottery ticket retail market generated slightly higher sales in 2010 relative to 2009 and signs of higher growth rates are emerging in early 2011. Despite the very difficult general retail environment in North America experienced in the last two years, instant lottery tickets have proven to be a very resilient generator of revenue. Low single digit growth rates are expected in 2011. Government jurisdictions are under significant pressure to generate more lottery revenues, which presents opportunities to provide additional product and services.

Lotteries outside North America are expected to generate similar growth rates as seen in North America, in the low single digit range in 2011.

Despite the improved outlook for retail sales of instant lottery tickets, strong competitive pressures coupled with economic challenges faced by many of our lottery clients have resulted in significant downward pressure on pricing throughout the industry. We believe these factors will continue to exist throughout 2011.

To combat these negative pressures, we have developed a formal change initiative process aimed at two specific objectives: increasing instant ticket sales and production volumes while, at the same time, significantly reducing our cost structures.

During 2011 we are targeting a significant increase in volumes over 2010. We currently have the customer contracts in place to achieve this and through more aggressive and effective marketing we believe our targeted volume growth is attainable.

The New Jersey Lottery contract has been extended until June 30, 2011 and the Lottery has indicated they will be issuing a request for proposal to award a new long-term contract. The New York Lottery contract (where we hold a secondary supplier contract) expires July 2011, and a new request for proposal has been issued by the New York Lottery. We have no other material customer contracts that come due in 2011 (when extensions are considered). There are a number of contracts currently held by our competitors which come up for re-bid in 2011 and we will bid aggressively on these new contract opportunities. We have recently been successful adding a number of new contracts to our portfolio including contracts for lotteries in Poland, Cambodia, Costa Rica and Norway.

A number of manufacturing and process improvement initiatives have been started in the fall of 2010 and will continue in 2011 to reduce our cost structure. In the fourth quarter we reduced our head count by approximately 30 positions. In addition, other initiatives underway include: plans to reduce spoilage

levels, more efficient processes to streamline our prior to press procedures, increased automation in all of our finishing plants, standardization of our game development area and continuing enhancements to our press efficiencies and improved procurement procedures to achieve reductions in variable costs such as inks and paper.

Cost savings from our fourth quarter restructuring will start to accumulate in the first quarter of 2011 and, coupled with the closure of our Kamloops facility earlier in 2010, will help establish a lower fixed cost base for our instant ticket product line.

Increasing volumes will have a significant impact on reducing our per unit costs as the fixed component of our costs is amortized over a larger base.

Specific cost containment strategies have also been put in place to reduce our overhead expenses in all areas of Pollard.

Sales and order volumes will vary on a quarter-to-quarter basis due to the timing of client orders, which vary based on marketing plans, new product offerings, inventory management and other factors. Volumes in the first quarter of the year are generally slightly lower than the rest of the year.

The importance of other service is growing as lotteries look to maximize their revenue and our Lottery Management Services are an important tool for our clients. After structural changes required in our Puerto Rico operation were implemented in the fourth quarter, the operations are now selling product at the retail level. We have recently added the distribution of the pull-tab product line for the Arizona Lottery to our contract portfolio. Licensed games and merchandise sales were higher in 2010, however competitive pressures resulted in lower gross margins. We are targeting higher sales in 2011.

The overall charitable gaming market remains stable and this is expected to continue during 2011. Improved product mix management generated stronger gross margins during the past year and we expect this to continue in 2011. We have recently initiated sales into a new jurisdiction which will provide an opportunity to expand the charitable game product line.

Our net operating cash flows have a large exposure to the U.S. dollar and some additional exposure to Euros. Significant swings in the Canadian dollar relative to the U.S. dollar will result in volatility in our reported Net Income due to write-downs in U.S. dollar denominated assets and liabilities such as accounts receivable, accounts payable and long-term debt denominated in U.S. dollars. The Canadian dollar continued strengthening relative to the U.S. dollar throughout 2010 and in early 2011, which had a significant negative impact on our operating results.

We currently do not have any foreign currency hedge contracts in place and will continue to monitor our foreign currency exposure as part of our risk management process.

We anticipate our capital expenditures will remain at similar levels to 2010 during the upcoming year as no major capital projects are currently planned.

Throughout 2011 we expect an improved cash flow to strengthen our balance sheet through a focus on reductions in debt.

Pollard believes that its credit facility and ongoing cash flow from operations will be sufficient to allow it to meet ongoing requirements for investment in capital expenditures, working capital and dividends at existing business levels.

### **Disclosure Controls and Procedures**

Under Multilateral Instrument 52-109, "Certification of Disclosure in Issuers' Annual and Interim Filings," issuers are required to document the conclusions of the Chief Executive Officer and Chief Financial Officer (the "Certifying Officers") regarding the design and effectiveness of the disclosure controls and procedures. Pollard's management, with the participation of the Certifying Officers of Pollard, has concluded that the disclosure controls and procedures as defined in Multilateral Instrument 52-109 are designed appropriately and are effective at providing reasonable assurance of achieving the disclosure objectives.

### **Internal Controls over Financial Reporting**

Under Multilateral Instrument 52-109, "Certification of Disclosure in Issuers' Annual and Interim Filings," issuers are required to document the conclusions of the Certifying Officers regarding the design and effectiveness of the internal controls over financial reporting. Pollard's management, with the participation of the Certifying Officers of Pollard, has concluded that the internal controls over financial reporting as defined in Multilateral Instrument 52-109 are designed appropriately and are effective at providing reasonable assurance of achieving the financial reporting objectives.

No changes were made in Pollard's internal control over financial reporting during the year ended December 31, 2010, that have materially affected, or are reasonably likely to materially affect, Pollard's internal control over financial reporting.

### **Additional Information**

Shares of Pollard Banknote Limited are traded on the Toronto Stock Exchange under the symbol PBL.

Additional information relating to Pollard, including the Audited Consolidated Financial Statements and the Annual Information Form for the year ended December 31, 2010, is available on SEDAR at [www.sedar.com](http://www.sedar.com).

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## **POLLARD BANKNOTE LIMITED**

### Management's Report

The accompanying consolidated financial statements and all the information contained in the annual report of Pollard Banknote Limited ("Pollard") are the responsibility of management and have been approved by the Board of Directors of Pollard. Financial and operating data elsewhere in the annual report is consistent with the information contained in the financial statements. The financial statements and all other information have been prepared by management in accordance with Canadian generally accepted accounting principles. The financial statements include some amounts and assumptions based on management's best estimates which have been derived with careful judgment.

In fulfilling its responsibilities, management of Pollard has developed and maintains a system of internal accounting controls. These controls are designed to ensure that the financial records are reliable for preparing the financial statements. The Board of Directors of Pollard carries out its responsibility for the financial statements through the Audit Committee. The Audit Committee reviews Pollard's annual consolidated financial statements and recommends their approval by the Board of Directors. The auditors have full access to the Audit Committee with and without management present.

The consolidated financial statements have been audited by KPMG LLP Chartered Accountants, whose opinion is contained in this annual report.

*"John Pollard"*

JOHN POLLARD  
Co-Chief Executive Officer

*"Robert Rose"*

ROBERT ROSE  
Chief Financial Officer

March 9, 2011

Consolidated Financial Statements of

**POLLARD BANKNOTE  
LIMITED**

Years ended December 31, 2010 and 2009



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## **INDEPENDENT AUDITORS' REPORT**

To the Shareholders of Pollard Banknote Limited

We have audited the accompanying consolidated financial statements of Pollard Banknote Limited (the company) which comprise the consolidated balance sheets as at December 31, 2010 and 2009, the consolidated statements of income, comprehensive income, deficit and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

### *Management's Responsibility for the Consolidated Financial Statements*

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditors' Responsibility*

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.



*Opinion*

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2010 and 2009, the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Signed “**KPMG LLP**”

Chartered Accountants

Winnipeg, Canada

March 9, 2011

# POLLARD BANKNOTE LIMITED

Consolidated Balance Sheets  
(In thousands of dollars)

December 31, 2010 and 2009

	2010	2009
<b>Assets</b>		
Current assets:		
Cash	\$ 5,405	\$ 3,706
Accounts receivable	14,528	16,361
Loan to Pollard Equities Limited (note 3)	2,157	12,572
Inventories (note 4)	17,889	20,259
Prepaid expenses and deposits	5,537	4,113
Net investment in leases due within one year	114	262
Future income taxes (note 10)	730	2,529
	46,360	59,802
Property, plant and equipment (note 5)	34,672	39,085
Net investment in leases (note 6)	40	194
Goodwill (note 7)	35,802	36,052
Intangible assets (note 8)	13,743	15,590
Future income taxes (note 10)	5,345	3,605
	\$ 135,962	\$ 154,328

	2010	2009
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 17,214	\$ 19,516
Dividends payable (note 11)	706	298
Distributions payable to Pollard Equities Limited (note 3)	2,157	13,392
Income taxes payable	139	655
	20,216	33,861
Long-term debt (note 9)	73,955	75,651
Other long-term liabilities	686	827
Foreign currency contracts	-	834
Interest rate swap contracts (note 21)	374	1,423
Future income taxes (note 10)	6,030	5,336
Shareholders' equity:		
Share capital (note 11)	73,209	73,209
Deficit	(35,401)	(33,405)
Accumulated other comprehensive loss (note 12)	(3,107)	(3,408)
	34,701	36,396
Commitments and contingencies (note 13)		
	\$ 135,962	\$ 154,328

See accompanying notes to consolidated financial statements.

On behalf of the Board:

"D.C. Crewson"      Director

"John Pollard"      Director

# POLLARD BANKNOTE LIMITED

Consolidated Statements of Income  
(In thousands of dollars, except for share amounts)

Years ended December 31, 2010 and 2009

	2010	2009
Sales	\$ 163,448	\$ 191,848
Cost of sales	132,034	153,025
	31,414	38,823
Expenses (income):		
Selling and administration	20,325	21,317
Interest (note 14)	5,202	4,398
Foreign exchange loss (gain)	(138)	845
Amortization of intangibles	1,984	1,926
Mark-to-market gain on foreign currency contracts	(834)	(9,807)
Mark-to-market gain on interest rate swap contracts (note 12)	(1,246)	(575)
Amortization of de-designated hedges (note 12)	1,233	587
Gain on sale of property, plant and equipment (note 17)	(1,834)	(1,740)
Conversion costs (note 1)	673	—
Warranty reserve	877	—
Restructuring expense (note 22)	1,169	—
Facility closing (note 23)	—	4,746
Other income	(127)	(523)
	27,284	21,174
Income before the undernoted	4,130	17,649
Employee profit sharing	593	886
Income before income taxes	3,537	16,763
Income taxes (note 10):		
Current	1,178	2,024
Future (reduction)	647	(288)
	1,825	1,736
Net income	\$ 1,712	\$ 15,027
Basic and diluted income per share	\$ 0.07	\$ 0.64
Weighted average number of shares outstanding	23,543,158	23,543,158

See accompanying notes to consolidated financial statements.

# POLLARD BANKNOTE LIMITED

Consolidated Statements of Comprehensive Income  
(In thousands of dollars)

Years ended December 31, 2010 and 2009

	2010	2009
Net income	\$ 1,712	\$ 15,027
Other comprehensive income (loss):		
Unrealized loss on translation of self-sustaining foreign operations	(661)	(2,328)
Unrealized gain (loss) on derivatives designated as cash flow hedges, net of income tax (reduction) of (\$64) and \$203	(113)	804
Amortization of de-designated hedges, net of income tax of \$158 and \$75	1,075	512
Other comprehensive income (loss), net of income tax	301	(1,012)
Comprehensive income	\$ 2,013	\$ 14,015

Consolidated Statements of Deficit  
(In thousands of dollars)

Years ended December 31, 2010 and 2009

	2010	2009
Opening balance	\$ (33,405)	\$ (32,026)
Net income	1,712	15,027
Dividends	(3,708)	(16,406)
Ending balance	\$ (35,401)	\$ (33,405)

See accompanying notes to consolidated financial statements.

# POLLARD BANKNOTE LIMITED

Consolidated Statements of Cash Flows  
(In thousands of dollars)

Years ended December 31, 2010 and 2009

	2010	2009
Cash increase (decrease):		
Operating activities:		
Net income	\$ 1,712	\$ 15,027
Items not involving cash:		
Amortization	8,578	8,882
Gain on sale of property, plant and equipment	(1,834)	(1,740)
Unrealized foreign exchange gain	(1,214)	(3,647)
Future income taxes (reduction)	647	(288)
Mark-to-market gain on foreign currency contracts	(834)	(9,807)
Mark-to-market gain on interest rate swap contracts	(1,246)	(575)
Amortization of de-designated hedges	1,233	587
Warranty reserve	877	—
Change in non-cash operating working capital (note 15)	(1,547)	5,526
	6,372	13,965
Investing activities:		
Additions to property, plant and equipment	(2,543)	(3,638)
Proceeds from sale of property, plant and equipment	2,953	3,422
Change in net investment in leases	293	1,172
Additions to intangible assets	(137)	(412)
	566	544
Financing activities:		
Increase in long-term debt	13	20,577
Change in other long-term liabilities	(139)	(537)
Increase in deferred financing charges	(831)	(567)
Change in loan to Pollard Equities Limited	10,415	3,829
Change in dividends payable	408	(199)
Change in distributions payable to Pollard Equities Limited	(11,235)	(4,376)
Dividends	(3,708)	(16,406)
	(5,077)	2,321
Foreign exchange loss on cash held in foreign currency	(162)	(18)
Change in cash position	1,699	16,812
Cash (bank indebtedness), beginning of year	3,706	(13,106)
Cash position, end of year	\$ 5,405	\$ 3,706
Supplementary cash flow information:		
Interest paid	\$ 4,581	\$ 4,643
Income taxes paid	1,795	1,503

See accompanying notes to consolidated financial statements.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements  
(In thousands of dollars, except for share amounts)

Years ended December 31, 2010 and 2009

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## 1. Description of the Corporation:

Pollard Banknote Limited ("Pollard"), formerly 7510101 Canada Limited, was incorporated under the laws of Canada on March 26, 2010.

On May 14, 2010, the operations of Pollard Banknote Income Fund (the "Fund") and its main operating affiliate Pollard Holdings Limited Partnership ("Pollard LP") converted, by way of a Plan of Arrangement (the "Conversion"), to a corporation, 7510101 Canada Limited, which was subsequently renamed Pollard Banknote Limited. Prior to the Conversion the Fund indirectly owned, through the Pollard Banknote Trust ("Trust"), approximately 26.7 percent of Pollard LP and the remaining approximately 73.3 percent was owned by Pollard Equities Limited ("Equities"). Pursuant to the terms of the Conversion, holders of Fund Units received, in exchange for each of their Fund Units, one common share of Pollard. Equities, the holder of the Class B and Class C Limited Partnership Units (collectively, the "Exchangeable LP Units") of Pollard LP and the associated Special Voting Units, received, in exchange for each group of one Exchangeable LP Unit (together with the accompanying Special Voting Units) one common share of Pollard.

As a result of the Conversion, Pollard became the 100 percent owner of both the Fund and Pollard LP, with Pollard LP continuing to operate the business.

The Conversion was accounted for as a continuity of interests method since there was no change of control. These consolidated financial statements incorporate the results of both the Fund and Pollard LP with the comparative figures having been restated to reflect the combined results of both entities. As the Canadian operations of Pollard are now taxable under the *Income Tax Act* (Canada), the difference between the tax values and the net book value of the Canadian assets and liabilities have been recorded as future tax assets and liabilities in the comparative figures.

These consolidated financial statements reflect the entities conducting the business of manufacturing and selling lottery and gaming products of the Pollard group as a corporation subsequent to May 14, 2010 and as an income trust and limited partnership prior to the Conversion. All references to "common shares" collectively refer to Pollard's common shares on and subsequent to May 14, 2010 and Fund Units and Class B and C Limited Partnership Units prior to the Conversion. All references to "dividends" refer to dividends paid or payable to holders of Pollard common shares on and subsequent to May 14, 2010 and to distributions payable to Fund Unitholders and Class B and C limited partnership Unitholders prior to the Conversion. All references to "shareholders" refer collectively to holders of Pollard common shares on and subsequent to May 14, 2010 and to Fund Unitholders and Class B and C limited partnership Unitholders prior to the Conversion.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for share amounts)

Years ended December 31, 2010 and 2009

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## 2. Significant accounting policies:

### (a) Principles of consolidation:

These consolidated financial statements include the accounts of Pollard and the following 100 percent owned subsidiaries:

- Pollard Holdings Limited Partnership
- Pollard Banknote GP Limited
- Pollard (U.S.) Ltd.
- Pollard Banknote Limited Partnership
- Pollard Holdings, Inc.
- Pollard Investments Limited
- Concursos y Promociones Pollard de Puerto Rico, Inc.
- Pollard Banknote Income Fund
- Pollard Banknote Trusts
- Pollard (Canada), Inc.
- PBL of Puerto Rico, Inc.
- Pollard Games, Inc.
- Nacako Sdn Bhd

All inter-company transactions have been eliminated.

Subsequent to year end Pollard Banknote Income Fund and Pollard Banknote Trust were wound up in conjunction with the completion of the final steps of the Conversion.

### (b) Revenue recognition:

Revenue is recognized when persuasive evidence of an arrangement exists, significant risks and benefits of ownership are transferred, the sales price to the customer is fixed or is determined and collection of the resulting receivable is reasonably assured. The significant risks of ownership and benefits of ownership are normally transferred in accordance with the shipping terms agreed to with the customer. Volume rebates are accrued and recorded as a reduction to sales based on historical experience and management's expectations regarding sales volume. Revenue related to lottery management services is recognized based on a percentage of lottery sales of instant lottery tickets pursuant to the terms of the contract.

### (c) Leases:

One of Pollard's subsidiaries has leasing operations which consist principally of the leasing of Pull Tab Vending Machines ("PTVM") with various private establishments. These leases are classified as sales-type leases. The PTVM leases have terms of three years. The net investment in sales-type leases consists of the present value of the future minimum lease payments. Interest revenue is recognized as a constant percentage return on the net investment.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

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## 2. Significant accounting policies (continued):

### (d) Inventories:

Raw materials, work-in-process and finished goods are valued at the lower of cost and net realizable value.

### (e) Goodwill:

Goodwill is comprised of the excess purchase price over the underlying carrying amount of the net assets sold as at August 5, 2005, as part of the 26.7 percent of Pollard LP sold in conjunction with the Initial Public Offering ("IPO") and the excess purchase price over the underlying carrying amount of the net assets acquired of Pollard's U.S. subsidiaries. Goodwill is not amortized but is subject to an annual impairment review to ensure its fair value remains greater than, or equal to, book value.

The impairment test is carried out in two steps. In the first step, the carrying amount of the reporting unit is compared with its fair value. When the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not to be impaired and the second step of the impairment test is unnecessary. The second step is carried out when the carrying amount of a reporting unit exceeds its fair value, in which case the implied fair value of the reporting unit's goodwill is compared with its carrying amount to measure the amount of the impairment loss, if any. The implied fair value of goodwill is determined in the same manner as the value of goodwill is determined, using the fair value of the reporting unit as if it was the purchase price. When the carrying amount of the reporting unit's goodwill exceeds the implied fair value of the goodwill, an impairment loss is recognized. Pollard performs the impairment tests on an annual basis. The annual impairment test was performed and it was determined that there was no impairment to the carrying value.

### (f) Intangibles:

Intangible assets with a finite life are amortized, on a straight-line basis, over their useful lives as follows:

Asset	Rate
Customer assets	16 years
Patents	6 to 15 years
Computer software	5 years
Deferred development	Duration of contract

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# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 2. Significant accounting policies (continued):

### (g) Property, plant and equipment:

Property, plant and equipment are stated at cost less investment tax credits. Amortization is provided on a straight-line basis over the estimated useful asset lives as follows:

Asset	Rate
Buildings	30 years
Leasehold improvements	Term of lease
Equipment	3 to 11 years
Furniture, fixtures and computers	3 to 9 years

Property, plant and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. No assets have been deemed to be impaired at December 31, 2010 and 2009.

### (h) Financial instruments:

#### *Recognition and measurement:*

Financial instruments are initially recorded at fair value and classified as one of the following: held-to-maturity, loans and receivables, held-for-trading, available-for-sale or other financial liabilities. Measurement of these instruments depends on the initial classification. Financial instruments held-for-trading are measured at fair value with gains and losses recognized in net income. Financial instruments held-to-maturity, loans and receivables and other financial liabilities are measured at amortized cost using the effective interest rate method. Changes in fair value are recognized in net income only if realized or impairment of value of an asset occurs. Available-for-sale instruments are measured at fair value with unrealized gains and losses recognized in other comprehensive income (loss) until such time as the asset or liability is derecognized or impaired at which time the amounts would be recorded in net income.

Transaction costs that are directly attributable to the acquisition or issuance of financial assets or liabilities, other than those classified as held-for-trading, are accounted for as part of the respective asset or liability carrying value.

Pollard has classified its foreign exchange and interest rate swap contracts as held-for-trading; accounts receivable and loan to Pollard Equities Limited as loans and receivables; and accounts payable and accrued liabilities, dividends payable, distributions payable to Pollard Equities Limited, long-term debt and other long-term liabilities as other financial liabilities. Pollard has neither available-for-sale nor held-to-maturity instruments.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

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## 2. Significant accounting policies (continued):

### *Comprehensive income:*

Comprehensive income is comprised of net income and other comprehensive income and is disclosed in the consolidated statements of comprehensive income. Comprehensive income is the change in net assets resulting from transactions or events from sources other than the shareholders. Other comprehensive income includes unrealized foreign exchange gains or losses on translation of the financial statements of subsidiaries that are self-sustaining foreign operations and gains or losses on the effective portion of derivatives designated as cash flow hedges, net of income taxes, in accordance with generally accepted accounting principles.

Accumulated other comprehensive loss is included in shareholders' equity on the consolidated balance sheet, which represents cumulative changes in other comprehensive income.

### *Derivatives:*

Pollard may use certain derivative financial instruments to manage risks of fluctuation in interest rates and foreign exchange rates. Pollard does not engage in the trading of these derivative financial instruments for profit.

Pollard's subsidiaries may enter into interest rate swap agreements in order to limit exposure to increases in interest rates and fix interest rates on certain portions of long-term debt. Pollard applies hedge accounting for certain interest rate swap agreements that meet the hedging criteria. The interest rate swap agreements are recognized in the balance sheets and measured at fair value with the effective portion of the gain or loss on the hedging item recognized in other comprehensive income and any ineffective portion recognized in net income. Payments and receipts under interest rate swap agreements designated as effective hedges are recognized as adjustments to interest expense on long-term debt in the same period that the underlying hedged transactions are recognized. Pollard formally documents the relationship between the hedging instrument and the hedged item, as well as the nature of the specific risk exposure being hedged and the intended term of the hedging relationship. The effectiveness of the hedge is assessed at inception and throughout the term of the hedge. Any hedging transactions that do not qualify for hedge accounting are marked-to-market at each period end with any resulting gains or losses recorded in income.

Pollard's subsidiaries may enter into foreign currency forward contracts to limit exposure on certain recognized assets or liabilities, firm commitments or foreign currency risk in an unrecognized firm commitment. The foreign currency contracts are recognized in the balance sheet and measured at fair value, with changes in fair value recognized currently in the statement of income.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

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## 2. Significant accounting policies (continued):

### (i) Translation of foreign currencies:

Pollard and its Canadian subsidiaries translate any amounts denominated in foreign currencies to Canadian dollars as follows: monetary assets and liabilities at effective rates prevailing at the end of the reporting period; non-monetary assets, non-monetary liabilities, revenue and expenses at effective rates prevailing at the time of the transaction. Gains or losses from translations are recognized in income in the period they occur.

Pollard (U.S.) Ltd., PBL of Puerto Rico, Inc., Concursos y Promociones Pollard de Puerto Rico, Inc. and Nacako Sdn Bhd are considered to be fully integrated operations and as a result their accounts have been translated into Canadian dollars in accordance with the temporal method as follows: monetary assets and liabilities at effective rates prevailing at the end of the reporting period; non-monetary assets and liabilities at effective rates prevailing at the time of the transaction; amortization expense at the rate in effect at the time the related assets are acquired; revenues and expenses at average rates prevailing during the reporting period. Gains or losses from translation are recognized in income in the period they occur.

Pollard Games, Inc. is considered to be a self-sustaining operation and as a result its accounts have been translated into Canadian dollars in accordance with the current rate method as follows: assets and liabilities at the exchange rate in effect at the balance sheet date and revenue and expenses are translated at the average rate for the reporting period. Translation adjustments arising from exchange rate fluctuations are shown as accumulated other comprehensive loss in shareholders' equity until realized, at which time they are recognized into income.

### (j) Employee future benefits:

Pollard maintains four non-contributory defined benefit pension plans in Canada and the United States, three being final pay plans and one being a flat benefit plan. None of the plans have indexation features. A market rate is used to measure benefit obligations. The expected return on pension plan assets is calculated on the fair value of the assets as of the year-end date.

The costs of Pollard's defined benefit plans are recognized over the period in which employees render service to Pollard in return for the benefits. These costs are actuarially determined using the projected benefit method pro-rated on service and management's best estimate of expected plan investment performance, salary escalation and retirement ages of employees.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)  
(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

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## 2. Significant accounting policies (continued):

Current service costs and interest costs on the benefit obligation are charged to income as they accrue. Past service costs, plan amendments, changes in assumptions, the net transitional asset amount and the cumulative unrecognized net actuarial gains and losses in excess of 10 percent of the greater of the benefit obligation or the fair value of plan assets are amortized to income on a straight-line basis over the expected average remaining service life of active plan members. The expected average remaining service life of the active employees covered by the defined benefit plans range from 12 to 13 years. Pollard's funding policy is consistent with statutory regulations.

Pollard's U.S. subsidiaries maintain two defined contribution plans in the United States. The pension expense for these plans is the annual funding contribution by the subsidiaries.

### (k) Income taxes:

Pollard and its incorporated subsidiaries are taxable entities and as such, income taxes are recorded to reflect the expected future tax consequences of temporary differences between the carrying amounts of assets and liabilities and their tax basis. Future income tax assets and liabilities are determined based on the enacted or substantively enacted tax rates, which are expected to be in effect when the underlying items of income and expense are expected to be realized. Valuation allowances are established when necessary to reduce the future tax assets to the amounts expected to be realized. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment. Income tax expense includes withholding taxes.

### (l) Use of estimates:

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of certain revenues and expenses during the year. Actual results could differ from those estimates.

### (m) Comparative figures:

Certain prior year amounts have been reclassified to conform to the current year's presentation.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

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## 2. Significant accounting policies (continued):

(n) Future changes in accounting policies:

In January, 2006, the Accounting Standards Board of Canada ("AcSB") announced that accounting standards in Canada are to converge with the International Financial Reporting Standards ("IFRS"). Canadian publicly accountable enterprises must adopt IFRS for their interim and annual financial statements relating to fiscal years beginning on or after January 1, 2011.

## 3. Loan to Pollard Equities Limited and distributions payable to Pollard Equities Limited:

Prior to the Conversion, Pollard Equities Limited exercised its right to receive its entitlement to monthly cash dividends by way of a loan. The loan to Pollard Equities Limited and the related distributions payable to Pollard Equities Limited were settled subsequent to December 31, 2010. For purposes of financial presentation, the loan receivable from and related distributions payable to Pollard Equities Limited have been presented separately as there is no legal right of offset against each of these balances.

## 4. Inventories:

	2010	2009
Raw materials	\$ 4,799	\$ 5,593
Work-in-process	935	753
Finished goods	12,155	13,913
	<u>\$ 17,889</u>	<u>\$ 20,259</u>

During 2010, Pollard recorded reversals of previous inventory write-downs of \$119, representing a decrease in the obsolescence reserves, and write-downs of \$56 due to changes in foreign exchange rates.

During 2009, Pollard recorded inventory write-downs of \$43, representing an increase in the obsolescence reserves, and write-downs of \$3 due to changes in foreign exchange rates.

The cost of goods sold reflects the costs of inventory including direct material, direct labour and manufacturing overheads.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 5. Property, plant and equipment:

December 31, 2010	Cost	Accumulated amortization	Net book value
Land	\$ 1,080	\$ —	\$ 1,080
Buildings	12,669	3,790	8,879
Leasehold improvements	1,349	763	586
Equipment	108,032	85,152	22,880
Furniture, fixtures and computers	3,945	2,698	1,247
	<u>\$ 127,075</u>	<u>\$ 92,403</u>	<u>\$ 34,672</u>

December 31, 2009	Cost	Accumulated amortization	Net book value
Land	\$ 1,288	\$ —	\$ 1,288
Buildings	15,135	5,225	9,910
Leasehold improvements	1,472	720	752
Equipment	106,487	80,758	25,729
Furniture, fixtures and computers	4,126	2,720	1,406
	<u>\$ 128,508</u>	<u>\$ 89,423</u>	<u>\$ 39,085</u>

## 6. Net investment in leases:

The following lists the components of the net investment in leases:

	2010	2009
Total minimum lease payments to be received	\$ 166	\$ 488
Unearned income (interest rate ranging from 9.4% to 11.3%)	(12)	(32)
	154	456
Less net investment in leases due within one year	114	262
	<u>\$ 40</u>	<u>\$ 194</u>

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 6. Net investment in leases (continued):

The minimum lease payments to be received in the next three fiscal years to expiry are as follows:

2011		\$	114
2012			46
2013			6
		\$	166

## 7. Goodwill:

Goodwill is comprised of \$30,620 (2009 - \$30,620), representing the excess purchase price over the underlying carrying amount of the net assets sold, as at August 5, 2005, as a result of the 26.7% of Pollard LP sold as part of Pollard Banknote Income Fund's IPO with the remaining \$5,182 (2009 - \$5,432) from Pollard's purchase of its U.S. subsidiaries.

During 2010 the value of goodwill decreased \$250 (2009 - \$847) as a result of changes in foreign exchange rates.

## 8. Intangible assets:

December 31, 2010	Cost	Accumulated amortization	Net book value
Customer assets	\$ 18,645	\$ 6,306	\$ 12,339
Patents	4,745	3,768	977
Deferred development costs	482	55	427
Computer software	229	229	—
	\$ 24,101	\$ 10,358	\$ 13,743

December 31, 2009	Cost	Accumulated amortization	Net book value
Customer assets	\$ 18,645	\$ 5,139	\$ 13,506
Patents	4,713	3,040	1,673
Deferred development costs	377	—	377
Computer software	229	195	34
	\$ 23,964	\$ 8,374	\$ 15,590

Amortization of intangible assets in 2010 was \$1,984 (2009 - \$1,926).

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 8. Intangible assets (continued):

Intangible assets includes the excess purchase price over the underlying carrying amount of the net assets sold, as at August 5, 2005, as a result of the 26.7 percent of Pollard LP that was sold as part of Pollard Banknote Income Fund's IPO.

## 9. Long-term debt:

	2010	2009
Term bank loan, interest of 4.06% to 6.70% payable monthly, maturing 2012	\$ 75,000	\$ 76,185
Deferred financing charges, net of amortization	(1,045)	(534)
	<u>\$ 73,955</u>	<u>\$ 75,651</u>

Included in the term bank loan balance is a U.S. dollar loan balance of US\$23,000 (\$23,000 Canadian equivalent).

Effective September 30, 2010, Pollard's subsidiaries' Pollard Holdings Limited Partnership and Pollard Holdings Inc. renewed their syndicated credit facility. The credit facility provides loans of up to \$70,000 for its Canadian operations and up to US\$25,000 for its U.S. subsidiaries. Borrowings under the credit facility bear interest at fixed and floating rates based on Canadian and U.S. prime bank rates, banker's acceptances or LIBOR. At December 31, 2010, the outstanding letters of guarantee drawn under the credit facility were \$4,661.

Under the terms and conditions of the credit facility agreement Pollard is required to maintain certain financial covenants including working capital ratios, debt to income before interest, income taxes, depreciation and amortization ("Adjusted EBITDA") ratios and certain debt service coverage ratios. As at December 31, 2010, Pollard is in compliance with all financial covenants.

Pollard's credit facility is secured by a first security interest in all of the present and after acquired property of Pollard and its operating subsidiaries. The credit facility can be prepaid without penalties. Under the terms of the agreement, the credit facility is committed for a one year period, renewable October 31, 2011. If the credit facility is not renewed, the loans are repayable one year after the credit facility expiry date. As such, the credit facility has effectively a two year term expiring October 31, 2012.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 9. Long-term debt (continued):

Under the credit facility, Pollard is required to repay principal amounts on a quarterly basis, beginning July 1, 2011, of an amount to be calculated based on 50% of the prior quarter's Free Cash Flow. Free Cash Flow is defined as Adjusted EBITDA less interest and current income taxes. The requirement to repay certain principal amounts is waived when the debt to adjusted earnings before interest, income taxes, depreciation and amortization ratio reaches certain target levels.

Pollard Holdings, Inc. entered into one interest rate swap agreement effectively converting variable rate debt obligations in the amount of US\$14,778 with underlying current floating rates of 0.56 percent plus applicable credit margin to a fixed rate of 2.95 percent plus applicable credit margin from August 31, 2010 to August 31, 2011.

## 10. Income taxes:

(a) Components of income tax provision:

The provision for income taxes is comprised of the following:

	2010	2009
Canada:		
Current income taxes	\$ 143	\$ 382
Future income taxes	930	763
	1,073	1,145
United States:		
Current income taxes	1,035	1,642
Future income tax reduction	(283)	(1,051)
	752	591
	\$ 1,825	\$ 1,736

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 10. Income taxes (continued):

### (b) Reconciliation to statutory rate:

The overall income tax provision differs from the amount that would be obtained by applying the combined statutory income tax rate to income due to the following:

	2010	2009
Income taxes at Canadian rates:		
Canadian combined federal and provincial income tax rate	29.7%	31.0%
Income taxes	\$ 1,052	\$ 5,197
Taxable (income) loss allocated to limited partners/ unitholders and therefore not subject to tax	595	(1,955)
Withholding taxes and other non-deductable amounts	543	194
Effect of non-taxable items related to foreign exchange	(365)	(1,700)
Provision for income taxes	\$ 1,825	\$ 1,736

### (c) Future income taxes:

Significant components of the future income tax assets and liabilities are as follows:

	2010	2009
Future income tax assets - current:		
Inventories	\$ 89	\$ 164
Accrued expenses and other reserves	594	2,282
Leasing transactions	47	83
	\$ 730	\$ 2,529
Future income tax assets - long-term:		
Foreign exchange	\$ 1,708	\$ 1,313
Property, plant and equipment	2,062	648
Intangible assets	1,575	1,644
	\$ 5,345	\$ 3,605
Future income tax liabilities - long-term:		
Property, plant and equipment	\$ (214)	\$ (283)
Goodwill and intangible assets	(4,731)	(5,053)
Reserves	(1,085)	-
	\$ (6,030)	\$ (5,336)

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 11. Share capital:

	2010	2009
Authorized:		
Unlimited common shares		
Unlimited preferred shares		
Issued:		
23,543,158 common shares	\$ 73,209	\$ 73,209

Dividends are paid on the common shares within 15 days of the end of each quarter and are fully discretionary, as determined by the Board of Directors of Pollard.

### *Capital management:*

Pollard's objectives in managing capital are to maintain a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. Pollard also strives to maintain an optimal capital structure to reduce the overall cost of capital.

In the management of capital, Pollard includes long-term debt, share capital and deficit, but excludes accumulated other comprehensive loss. The Board of Directors regularly monitors the levels of debt, equity and dividends.

Pollard monitors capital on the basis of funded debt to Adjusted EBITDA, working capital ratio and debt service coverage. Pollard has externally imposed capital requirements as determined through its bank credit facility. Under the syndicated credit facility, Pollard has agreed not to pay dividends in excess of the current quarterly amount of \$0.03 per share until the debt to adjusted earnings before interest, income taxes, depreciation and amortization ratio is reduced to a certain level. As at December 31, 2010, Pollard is in compliance with all financial covenants.

On January 6, 2010, Pollard declared a dividend of \$0.0475 for the month of January, payable February 15, 2010. On January 28, 2010, Pollard changed its dividend policy. Dividends of \$0.01 per share were declared for the months of February (payable March 15, 2010), March (payable April 15, 2010) and April (payable May 14, 2010).

Following the Conversion, Pollard initiated a dividend rate of \$0.03 per share per quarter. The dividend declared on May 5, 2010, to shareholders of record on June 30, 2010, payable July 15, 2010, was \$0.02 per share relating to the months of May and June.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 11. Share capital (continued):

On August 4, 2010, a dividend of \$0.03 per share was declared, payable to shareholders of record on September 30, 2010. On November 3, 2010, a dividend of \$0.03 per share was declared, payable to shareholders of record on December 31, 2010.

There were no other changes in Pollard's approach to capital management during the current year.

## 12. Accumulated other comprehensive loss:

	2010	2009
Translation of financial statements of self-sustaining foreign operations:		
Balance, beginning of year	\$ (2,188)	\$ 140
Unrealized loss on translation of financial statements of self-sustaining foreign operations	(661)	(2,328)
Balance, end of year	(2,849)	(2,188)
Derivatives designated as cash flow hedges:		
Balance, beginning of year	(1,220)	(2,536)
Unrealized gain (loss) on derivatives designated as cash flow hedges, net of income tax (reduction) of (\$64) and \$203	(113)	804
Amortization of de-designated hedges, net of income tax of \$158 and \$75	1,075	512
Balance, end of year	(258)	(1,220)
Total accumulated other comprehensive loss	\$ (3,107)	\$ (3,408)

With the new credit facility established during 2009, two of the three existing interest rate swap agreements no longer met the criteria for hedge accounting. As a result of the de-designation of the hedge accounting a non-cash loss of \$1,820 was amortized into net income over the twelve months ending August 31, 2010. A non-cash loss of \$1,233 (2009 - \$587) was recorded in net income and a corresponding gain, net of future taxes of \$158 (2009 - \$75), was recorded in other comprehensive income in the year ended December 31, 2010, due to the de-designation of the hedge accounting. Beginning September 1, 2009, any changes in the fair value of these two interest rate swap agreements were credited directly to income. For the year ending December 31, 2010, a gain of \$1,246 (2009 - \$575) was recorded in net income.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

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## 13. Commitments and contingencies:

Certain Pollard subsidiaries rent premises and equipment under long-term operating leases. The following is a schedule by fiscal year of rental payment commitments under operating leases outstanding:

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2011	\$	3,084
2012		2,946
2013		2,794
2014		2,756
2015		2,751
Thereafter		13,448

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Pollard's subsidiaries are contingently liable for outstanding letters of guarantee in the amount of \$4,661 at December 31, 2010 (2009 - \$5,183). These letters of guarantee are part of Pollard's credit facility and are secured as disclosed in note 9.

During 2008 Pollard entered into a sale leaseback with an affiliate of Equities for land and building in Council Bluffs, Iowa. The property was sold for CDN\$4,081 and leased back for ten years at an annual lease rate of approximately US\$260. The sale value was determined through independent sources.

Pollard is involved in litigation and claims associated with operations, the aggregate amounts of which are not determinable. While it is not possible to estimate the outcome of the proceedings, management is of the opinion that any resulting settlements would not materially affect the financial position of Pollard. Should losses occur on resolution of these claims, such loss would be accounted for as a charge to income in the period in which the settlement occurs.

Pollard has agreed to indemnify Pollard's current and former directors and officers from and against liability and costs in respect of any action or suit against them in connection with the execution of their duties of office, subject to certain usual limitations. No claims with respect to such occurrences have been made and, as such, no amount has been recorded in these financial statements with respect to these indemnifications.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 14. Interest:

	2010	2009
Interest expense incurred on:		
Long-term debt	\$ 5,010	\$ 3,921
Other	192	477
	<u>\$ 5,202</u>	<u>\$ 4,398</u>

## 15. Supplementary cash flow information:

	2010	2009
Change in non-cash operating working capital:		
Accounts receivable	\$ 1,735	\$ 3,059
Inventories	2,124	(432)
Prepaid expenses and deposits	(1,882)	(2,151)
Accounts payable and accrued liabilities	(3,028)	4,658
Income taxes payable	(496)	392
	<u>\$ (1,547)</u>	<u>\$ 5,526</u>

## 16. Pension benefits:

Pollard sponsors non-contributory defined benefit plans providing pension benefits to its employees. Pollard has four pension plans of which three are final pay plans and one is a flat benefit plan. None of the plans have indexation features. The measurement date for all the plans is December 31. The two plans of the U.S. subsidiaries require valuations annually with the last valuations being as of January 1, 2010. One of the Canadian plans of Pollard requires valuation every year with the last valuation as of December 31, 2009. The other Canadian plan of Pollard requires valuation every four years with the last valuation as of January 1, 2008. Pollard's U.S. subsidiaries also maintain two defined contribution plans. The pension expense for these defined contribution plans is the annual funding contribution by the subsidiaries.

Due to the closing of the Kamloops facility in 2009 (see note 23) a pension curtailment gain of \$466 was recognized in 2009 due to the revaluation of the expected pension obligation.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 16. Pension benefits (continued):

Information about Pollard's defined benefit plans, in aggregate, is as follows:

	2010	2009
<i>Benefit plan assets:</i>		
Fair value, beginning of year	\$ 18,421	\$ 14,658
Actual return on plan assets	1,631	2,271
Employer contributions	2,935	2,575
Benefits paid	(927)	(768)
Other	(114)	(315)
<b>Fair value, end of year</b>	<b>\$ 21,946</b>	<b>\$ 18,421</b>
<i>Accrued benefit plan obligations:</i>		
Balance, beginning of year	\$ 18,375	\$ 14,711
Current service cost	1,344	1,360
Interest cost	1,189	1,063
Benefits paid	(927)	(768)
Actuarial loss	2,152	2,985
Pension curtailment gain	—	(466)
Other	(111)	(510)
<b>Balance, end of year</b>	<b>22,022</b>	<b>18,375</b>
Excess (deficit) of plan assets versus plan obligations	(76)	46
Unamortized net actuarial loss	3,363	1,600
<b>Net deferred pension asset</b>	<b>\$ 3,287</b>	<b>\$ 1,646</b>
<i>Recognized in the consolidated balance sheets as follows:</i>		
Prepaid expenses and deposits	\$ 3,287	\$ 1,646
<b>Net accrued benefit plan asset</b>	<b>\$ 3,287</b>	<b>\$ 1,646</b>

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 16. Pension benefits (continued):

Included in the accrued benefit plan obligations and the fair value of benefit plan assets at year end are the following amounts in respect of plans with accrued benefit plan obligations in excess of plan assets:

	2010	2009
Accrued benefit plan obligations	\$ 5,899	\$ 7,068
Fair value of benefit plan assets	4,728	6,182
Deficit	\$ 1,171	\$ 886

The total net cost for Pollard's defined benefit and defined contribution pension plans is as follows:

	2010	2009
<i>Net defined benefit plans cost:</i>		
Current service cost	\$ 1,344	\$ 1,360
Interest on plan obligations	1,189	1,063
Actual return on plan assets	(1,631)	(2,271)
Difference between expected return and actual return on plan assets	384	1,212
Amortization of actuarial gains and losses	33	47
Pension curtailment gain	—	(466)
Net defined benefit plans cost	1,319	945
Defined contribution plans cost	157	173
Net pension plans cost	\$ 1,476	\$ 1,118

The significant actuarial assumptions adopted in measuring Pollard's accrued benefit obligations are as follows:

	2010	2009
Discount rate	6%	6% to 6.5%
Rate of compensation increase	0% to 3%	0% to 3.5%

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 16. Pension benefits (continued):

The significant actuarial assumptions adopted in measuring Pollard's pension cost are as follows:

	2010	2009
Discount rate	6% to 6.5%	6% to 7.5%
Expected long-term rate of return on plan assets	6.5%	6.5%
Rate of compensation increase	0% to 3%	0% to 3.5%

The benefit plan assets are held in trust and are invested as follows:

	2010	2009
Equities	59.7%	57.5%
Bonds	37.3%	39.8%
Cash and cash equivalents	3.0%	2.7%
	100.0%	100.0%

## 17. Related party transactions:

During the year ended December 31, 2010, Pollard paid property rent of \$2,693 (2009 - \$1,996) and \$95 (2009 - nil) in plane charter costs to affiliates of Equities. During the year, Equities paid Pollard \$72 (2009 - \$72) for accounting and administration fees.

At December 31, 2010, included in accounts payable and accrued liabilities is an amount owing to Equities and its affiliates for rent and other expenses of \$721 (2009 - \$293).

During the year ended December 31, 2010, Pollard disposed of a building and land in Kamloops, British Columbia to an affiliate of Equities for total proceeds of \$2,900 resulting in a gain of \$1,838. The selling price was based on the current fair market value as determined through an independent appraisal.

During the year ended December 31, 2009, Pollard disposed of a surplus office building and land in Winnipeg, Manitoba to an affiliate of Equities for total proceeds of \$3,400 resulting in a gain of \$1,737. The selling price was based on the current fair market value as determined through an independent appraisal.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 17. Related party transactions (continued):

Included in accounts payable and accrued liabilities is an amount owing of \$500 (2009 - \$500) to Equities. According to the terms of the Investment Agreement dated July 27, 2005, Equities agreed to indemnify Pollard for all costs relating to certain outstanding litigation at the time of the IPO, including litigation relating to the closure of Imprimerie Spéciale de Banque (ISB), a French subsidiary of the predecessor company to Pollard which ceased operations as of November 15, 1999. The indemnity was subject to an overriding requirement for Pollard to absorb the first \$500 of any indemnified costs. The litigation relating to ISB was settled in 2009 by Equities for \$1,798 and as such, Pollard is required to reimburse \$500 to Equities. The \$500 liability was originally accrued at the time of the August 5, 2005, IPO as Pollard's expected share of the liability related to the ISB litigation.

## 18. Sales to major customers:

For the year ended December 31, 2010, sales to one customer amounted to approximately 11 percent of consolidated sales (2009 - 12 percent).

## 19. Segmented information:

Pollard's operations consist of one reporting segment principally in the manufacturing and sale of lottery and charitable gaming products. Geographic distribution of sales, property, plant and equipment and goodwill are as follows:

	2010	2009
Sales:		
Canada	\$ 39,027	\$ 46,533
U.S.	76,381	107,578
Other	48,040	37,737
<b>Total</b>	<b>\$ 163,448</b>	<b>\$ 191,848</b>
Property, plant and equipment and goodwill:		
Canada	\$ 53,592	\$ 57,505
U.S.	16,882	17,632
	<b>\$ 70,474</b>	<b>\$ 75,137</b>

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)  
(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

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## 20. Financial instruments:

The fair value of a financial instrument is the estimated amount that Pollard would receive or pay to terminate the instrument agreement at the reporting date. The following methods and assumptions were used to estimate the fair value of each type of financial instrument by reference to various market value data and other valuation techniques as appropriate.

The fair values of accounts receivable, loan to Pollard Equities Limited, accounts payable and accrued liabilities and dividends payable approximate their carrying values given their short-term maturities.

The fair value of the investment in leases approximate the carrying value as the interest rates implicit in the leases approximate rates for similar type instruments.

The fair value of the long-term debt approximates the carrying value due to the variable interest rate of the debt.

The fair value of the other long-term liabilities approximates the carrying value based on the expected settlement amount of these liabilities.

The fair value of foreign currency forward contracts is estimated utilizing market forward rates of exchange.

The fair value of the interest rate swap contracts is based on the amount at which they could be settled using current interest rates.

Certain financial instruments recorded at fair value on the balance sheet are classified using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy has the following levels:

Level 1 - valuation based on the quoted prices observed in active markets for identical assets or liabilities

Level 2 - valuation techniques based on inputs that are quoted prices of similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; other than quoted prices used in a valuation model that are observable for that instrument; and inputs that are derived principally from or corroborated by observable market data by correlation or other means

Level 3 - valuation techniques with significant unobservable market inputs

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

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## 20. Financial instruments (continued):

A financial instrument is classified to the lowest level of the hierarchy for which a significant input has been considered in measuring fair value.

As at December 31, 2010, the cash recorded at fair value is classified as level one and interest rate swap contracts recorded at fair value in the consolidated balance sheet are classified as level two, of the fair value hierarchy.

## 21. Financial risk management:

Pollard has exposure to the following risks from its use of financial instruments:

- Credit risk
- Liquidity risk
- Currency risk
- Interest rate risk

Pollard's risk management policies are established to identify and analyze the risks, to set appropriate risk limits and controls and to monitor risks and adherence to limits. The Audit Committee oversees how management monitors compliance with Pollard's risk management policies and procedures. The Audit Committee is assisted in its oversight role by Internal Audit, who undertakes regular reviews of risk management controls and utilizes the annual risk assessment process as the basis for the annual internal audit plan.

### *Credit risk:*

Credit risk is the risk of financial loss if a customer or counterparty to a financial instrument fails to meet its financial obligations.

Credit risk on Pollard's accounts receivable is minimized since they are mainly from governments and their agencies and are collected in a relatively short period of time. Credit risk on Pollard's net investment in leases is minimized since they are dispersed among a large, diversified group of customers. Credit risk on foreign currency and interest rate swap contracts is minimized since the counterparties are restricted to Schedule 1 Canadian financial institutions.

The carrying amount of accounts receivable is reduced through the use of an allowance account and any adjustment to the allowance is recognized in the statement of income within selling and administration expense. When a receivable balance is considered uncollectible, it is written off against the allowance account.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)

(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

## 21. Financial risk management (continued):

The following table outlines the details of the aging of Pollard's receivables and the related allowance for doubtful accounts:

	2010	2009
Current	\$ 12,388	\$ 12,693
Past due for 1 to 60 days	1,648	3,019
Past due for more than 60 days.	594	825
Less: Allowance for doubtful accounts	(102)	(176)
	\$ 14,528	\$ 16,361

### *Liquidity risk:*

Liquidity risk is the risk that Pollard will not be able to meet its financial obligations as they fall due. Pollard's approach is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due. In addition, Pollard maintains a committed credit facility including up to \$70,000 for its Canadian operations and up to US\$25,000 for its U.S. subsidiaries. At December 31, 2010, the unused balance available for drawdown was \$15,339.

The 2011 requirements for capital expenditures, working capital and distributions are expected to be financed from cash flow provided by operating activities and unused credit facility. Pollard enters into contractual obligations in the normal course of business operations.

### *Currency risk:*

Pollard sells a significant portion of its products and services to customers in the United States and to international customers where sales are denominated in U.S. dollars. In addition, a significant portion of its cost inputs are denominated in U.S. dollars. Pollard also generates a small amount of revenue in currencies other than the Canadian and U.S. dollar, primarily in Euros.

Pollard utilizes a number of strategies to mitigate its exposure to currency risk. Two manufacturing facilities are located in the U.S. and a significant amount of cost inputs for all production facilities are denominated in U.S. dollars, offsetting a large portion of the U.S. dollar revenue in a natural hedge. Pollard may also utilize foreign currency forward contracts to hedge against the net U.S. dollar exposure.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)  
(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

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## 21. Financial risk management (continued):

A 50 basis point strengthening/weakening in the foreign exchange rate between the Canadian and U.S. dollar would decrease/increase the income before income taxes due to changes in operating cashflow by \$180 for the year ended December 31, 2010.

In addition, translation differences arise when foreign currency monetary assets and liabilities are translated at foreign exchange rates that change over time. As at December 31, 2010, the amount of financial liabilities denominated in U.S. dollars exceeds the amount of financial assets denominated in U.S. dollars by approximately \$14,026. A 50 basis point weakening/strengthening in the value of the Canadian dollar relative to the U.S. dollar would result in a decrease/increase in net income of approximately \$70.

### *Interest rate risk:*

Pollard is exposed to interest rate risk relating to its fixed and floating rate instruments. Fluctuation in interest rates will have an effect on the valuation and repayment of these instruments. As at December 31, 2010, Pollard had entered into an interest rate swap contract to fix the interest rates on approximately 20 percent of the long-term debt for a period of eight months. This interest rate swap contract allows one of Pollard's subsidiaries to receive interest at floating rates and pay interest at a fixed rate.

Pollard Holdings, Inc., a subsidiary, entered into one interest rate swap agreement effectively converting variable rate debt obligations in the amount of US\$14,778 with underlying current floating rates of 0.56 percent plus applicable credit margin to a fixed rate of 2.95 percent plus applicable credit margin from August 31, 2010 to August 31, 2011.

A 50 basis point decrease/increase in interest rates would result in an increase/decrease in income before income taxes of \$326 for the year ended December 31, 2010.

## 22. Restructuring expense:

In the fourth quarter of 2010 approximately 30 salaried positions were eliminated. The restructuring expense includes severance payments and related fringe totaling approximately \$886 with approximately \$500 to be paid out in 2011.

In addition, due to changes in the local rules regulating scratch off lottery tickets, our Puerto Rico Lottery operation was restructured to comply with the new rules. Costs incurred of approximately \$283 include the write off of existing inventory and the overhead costs incurred during the transition to the new product line.

# POLLARD BANKNOTE LIMITED

Notes to Consolidated Financial Statements (continued)  
(In thousands of dollars, except for unit amounts)

Years ended December 31, 2010 and 2009

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## **23. Facility closing:**

On November 5, 2009, Pollard announced the closing of its Kamloops production facility effective February 28, 2010. In 2009 a facility closing reserve of \$4,746 was incurred primarily representing employee severance and related fringe costs. The cash outlays related to the facility closing accrual will be expended, starting March 1, 2010, over a period of approximately two years, consistent with the terms of their salary and benefit continuance based on their individual weeks of severance.

As of December 31, 2010, Pollard had expended approximately \$4,251 of the facility closing reserve.